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The Supreme Court Considers Challenge to Key Legal Theory in Class Action Securities Litigations

March 6, 2014

The Supreme Court heard oral arguments yesterday in *Halliburton Co. v. Erica P. John Fund, Inc.* (13-317), a case with the potential to have major ramifications on the future of private securities fraud class actions. At stake is the continued viability of the rebuttable presumption that all putative class members relied on an alleged misrepresentation when they purchased securities in an efficient market. That presumption is vital for plaintiffs in the majority of class action securities litigations. At oral argument, the Supreme Court justices' questions indicated that a majority may not be prepared to completely eliminate the presumption. However, there may be enough support to require that plaintiffs make a heightened showing at the class certification stage that the presumption is warranted.

To recover damages in a private securities fraud action under Section 10(b) of the Securities Exchange Act of 1934 ("the Exchange Act") and Securities and Exchange Commission Rule 10b–5, a plaintiff must prove, among other things, reliance on a material misrepresentation or omission made by the defendant. In *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (Blackmun, J.), the Supreme Court found that "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would" prevent securities fraud plaintiffs "from proceeding with a class action, since individual issues" of reliance would "overwhelm[ ] the common ones." The *Basic* Court endorsed a "fraud-on-the market" theory, which permits securities fraud plaintiffs to invoke a rebuttable presumption of reliance on public, material misrepresentations regarding securities traded in an efficient market. However, the *Basic* Court ruled that "[a]ny 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."

In *Halliburton*, the Court has been asked to overrule or substantially modify the presumption of classwide reliance derived from the fraud-on-the-market theory endorsed by the *Basic* Court. Alternatively, the *Halliburton* Court was asked to reaffirm that a defendant may rebut the presumption of reliance and defeat class certification by introducing evidence that the alleged misrepresentation did not distort the market price of the stock.

THE FRAUD-ON-THE-MARKET PRESUMPTION ADOPTED IN *BASIC INC. V. LEVINSON*

The fraud-on-the-market theory endorsed by the *Basic* Court has two central premises. First, "[a]n investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price." Second, "most publicly available

The Report From Washington is published by the Washington, D.C. office of Simpson Thacher & Bartlett LLP.

information is reflected in [the] market price [of a security.]" In endorsing the theory, the Court cited empirical studies that "tended to confirm" that the "market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations."

Justices White and O'Connor dissented in part from the majority opinion in *Basic* insofar as it adopted the fraud-on-the-market presumption of reliance. Among other concerns, the dissent stated that "the economists' theories which underpin the fraud-on-the-market presumption… are—in the end—nothing more than theories which may or may not prove accurate upon further consideration." The dissent expressed "doubt" concerning the Court's ability "to assess which theories aptly describe the functioning of the securities industry."

Recently, in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, 133 S. Ct. 1184 (2013) (Ginsburg, J.),[1] four Supreme Court Justices voiced reservations concerning the continued viability of *Basic*'s fraud-on-the-market presumption. Justice Alito, concurring, observed that "recent evidence suggests that the [fraud-on-the-market] presumption may rest on a faulty economic premise" and suggested that "reconsideration of the *Basic* presumption may be appropriate." Justice Thomas, dissenting, joined by Justices Kennedy and Scalia, observed that "[t]he *Basic* decision itself is questionable" and noted that the *Basic* dissent's concerns with the economic theories underlying the fraud-on-the-market presumption "remain valid today."

CASE BACKGROUND

The underlying litigation in *Halliburton Co. v. Erica P. John Fund, Inc.* (13-317) involves securities fraud claims brought against Halliburton Company and its CEO, President, and Chairman of the Board, David Lesar (collectively, "Halliburton") in connection with alleged misstatements concerning Halliburton's revenues, projected liability for asbestos claims, and the anticipated cost savings and efficiencies of Halliburton's 1998 merger with Dresser Industries.

This is the second time the case has gone up to the Supreme Court. In November 2008, the Northern District of Texas relied on Fifth Circuit precedent to deny plaintiffs' motion for class certification because plaintiffs had failed to establish that their losses were caused by Halliburton's alleged misstatements. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 2008 WL 4791492 (N.D. Tex. Nov. 4, 2008) (Lynn, J.). The Fifth Circuit affirmed the district court's ruling in February 2010. *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010) (Reavley, J.). However, on June 6, 2011, the Supreme Court unanimously held that the Fifth Circuit had "erred by requiring proof of loss causation for class certification." *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (2011) (Roberts, C.J.). The Supreme Court remanded the action to the Fifth Circuit for consideration of any additional arguments that Halliburton had preserved in opposition to class certification. The Fifth Circuit, in turn, remanded the case to the Northern District of Texas.

Back in the district court, Halliburton argued that the class should not be certified because the evidence showed that the alleged misrepresentations did not affect the price of the company's shares. The district court declined to consider this evidence, finding that defendants may not rebut the fraud-on-the-market presumption at the class

[1] The *Amgen* Court held that plaintiffs do not have to prove materiality to obtain class certification in fraud-on-the-market cases brought under Section 10(b) and Rule 10b-5.

certification stage by showing an absence of price impact. Halliburton appealed. In its April 30, 2013 decision, the Fifth Circuit relied on the Supreme Court's decision in *Amgen*, 133 S. Ct. 1184, to hold that "price impact fraud-on-the-market rebuttal evidence should not be considered at class certification." *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423, 435 (5th Cir. 2013) (Davis, J.). Halliburton successfully petitioned the Supreme Court for certiorari of the Fifth Circuit's decision.

MERITS BRIEFING

Halliburton's Arguments

In its merits brief, Halliburton goes straight for the jugular: "*Basic* was wrong when it was decided and time has only made things worse." Br. For Petitioners, No. 13-317, *Halliburton Co. v. Erica P. John Fund, Inc.*, 2013 WL 6907610, at *11 (Dec. 30, 2013). Halliburton advances several arguments for overturning *Basic*, including:

- Principles of Statutory Construction. Halliburton argues that because the Section 10(b) action is a "judicial construct that Congress did not enact," the Court should look to the most analogous express cause of action in the Exchange Act to infer how the 1934 Congress would have addressed the issue. Halliburton asserts that Section 18(a) of the Exchange Act is the closest analogue to the Section 10(b) action because "only Section 18(a) broadly authorizes damages for misrepresentations by a defendant who did not buy from or sell to the plaintiff when those statements affect aftermarket trading - the basis for most Section 10(b) suits." Halliburton contends Section 18(a) requires actual reliance because it allows recovery only by those "who, in reliance upon such [false or misleading] statement, shall have purchased or sold a security at a price which was affected by such statement."
- Economic Theory. Halliburton posits that the fraud-on-the-market theory underpinning the presumption of reliance is based on a "simplistic understanding of market efficiency [that] is at war with economic reality." Specifically, "investors do not uniformly rely on the integrity of the market price, which does not rationally reflect all public information, even in developed markets."
- Recent Precedent in Class Certification Cases. Halliburton observes that the Court's recent decisions on class actions make the *Basic* presumption increasingly anomalous. Specifically, in *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011) (Scalia, J.), the Court held that statistical evidence and sociological testimony concerning alleged gender discrimination was insufficient proof of the existence of common issues, given the diversity of outcomes among class members. Similarly, in *Comcast Corp. v. Behrend,* 133 S. Ct. 1426 (2013) (Scalia, J.), the Court held it was error to certify a class without determining whether the methodology that purported to show predominance of common damages issues "[was] a just and reasonable inference or [was] speculative."

Alternatively, Halliburton contends that plaintiffs should be required to show that the alleged misrepresentations actually distorted the market price for the security before invoking the presumption of reliance. Halliburton argues that it "makes scant sense to presume that plaintiffs relied on alleged misrepresentations by purchasing at a distorted market price without asking whether the misrepresentation actually distorted that price in the first place."

The Fund's Arguments

Plaintiff Erica P. John Fund, Inc. ("the Fund") takes the position that *Basic* was correctly decided and should not be overruled or modified. Br. For Respondent, No. 13-317, *Halliburton Co. v. Erica P. John Fund, Inc.*, 2014 WL 356636 (Jan. 29, 2014). In its merits brief, the Fund sets forth several arguments in favor of maintaining the presumption of reliance established by the *Basic* Court, including:

- *Basic's* "Common-Sense Rationale and Application." The Fund disputes Halliburton's argument that the bases for the fraud-on-the market theory have been discredited. According to the Fund, "[i]n markets to which the presumption applies, material statements typically affect the price of a stock…. Ordinary investors generally rely on the integrity of the market price, rather than studying the myriad disclosures of publicly-traded companies. When the stock price is inflated or kept from declining in value by a material misrepresentation, all purchasers are effectively relying in common on that misrepresentation."
- *Stare Decisis*. The Fund argues that "[p]rinciples of *stare decisis* apply with full force to *Basic*, a twenty-five-year-old precedent that this Court has cited favorably five times within the last ten years (including in this very case three years ago)." The Fund emphasizes the fact that "Congress has not disturbed *Basic* despite twice engaging in a comprehensive reappraisal of the law governing private securities actions."
- *Basic* "Faithfully Tracks" the Exchange Act. The Fund contends that "[t]he Court in *Basic* grounded its decision in the securities laws, particularly the Exchange Act, which Congress enacted to facilitate an investor's reliance on the integrity of [the securities] markets." The Fund cites favorably the *Basic* Court's finding that the presumption of reliance is "consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act, because Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets."
- Deterrence. The Fund warns that "[o]verruling *Basic* would mean the demise of private securities actions and the deterrent and compensatory role they serve." According to the Fund, individual investors "simply do not have the time to review financial statements, SEC filings, and the like, and thus could never establish actual reliance even in an individual action."

The Fund also argues against Halliburton's position that courts should address at the class certification stage the issue of whether the price of the security was impacted by the alleged misrepresentation. "As the Fifth Circuit correctly recognized, the existence of 'price impact' does not inform whether common questions predominate over individual ones. Instead, absent price impact, all the plaintiffs' claims fail together."

Amicus Briefs

The Supreme Court received several amicus briefs on both sides. The United States filed an amicus brief in support of the Fund, arguing that "meritorious private securities fraud actions, including class actions, are an essential supplement to criminal prosecutions and civil enforcement actions brought by the Department of Justice and the SEC." Br. for the United States as Amicus Curiae Supporting Respondent, No. 13-317,

Halliburton Co. v. Erica P. John Fund, Inc., 2014 WL 466853, at *1-2 (Feb. 5, 2014).

In support of Halliburton, a group of former SEC Commissioners and officials, as well as leading law professors, filed a brief in which they contend that "[t]his Court need not wade into the complex and highly technical debate over the efficient markets hypothesis to answer the question presented here. Instead, the Court can, and should, decide this case by applying well-established principles of statutory construction." Br. for Former SEC Commissioners and Officials and Law Professors as Amici Curiae Supporting Petitioners, No. 13-317, *Halliburton Co. v. Erica P. John Fund, Inc.*, 2014 WL 69391, at *9 (Jan. 6, 2014).

An amicus brief also was filed by two distinguished law professors (the "Law Professors") addressing the second question presented – whether courts should consider evidence of price impact (of lack thereof) at the class certification stage. The Law Professors answered that question in the affirmative: "[T]he Court should shift the focus of fraud on the market inquiries from a market's overall efficiency to the question whether the alleged fraud affected market price." Br. of Law Professors as Amici Curiae in Support of Petitioners, No. 13-317, *Halliburton Co. v. Erica P. John Fund, Inc.*, 2014 WL 60721, at *4 (Jan. 6, 2014). The Law Professors advocate the use of "event studies" as a "reliable and practicable method for courts to determine whether misstatements distorted the market." *Id.* at *25. An event study is a "regression analysis that measures the effect of an event, such as a firm's earnings announcement, on a firm's stock price." *Id.* The Law Professors assert that "if an event study shows that a misrepresentation or a corrective disclosure had a statistically significant effect on the price of a stock, then the market may be said to have 'relied' on the misrepresentation." *Id.* at *25-26. The Law Professors' position is that the market impact study should be conducted at the class certification stage. "[P]utative classes that cannot show that a fraud on the market took place through proof of market impact should not receive the benefit of a broad presumption of reliance." *Id.* at *31-32.

ORAL ARGUMENT HIGHLIGHTS

" How am I supposed to review the economic literature and decide which of you is correct on that?"

- Chief Justice Roberts

At oral argument, the Supreme Court justices' questions indicated that a majority may not be prepared to require that plaintiffs prove actual reliance. Some of the justices who had previously expressed skepticism of *Basic* seemed to gravitate towards the position advocated by the Law Professors that plaintiffs should be required at the class certification stage to prove price impact through event studies.

Justice Kennedy, a potential swing vote, referred to the Law Professors' advocacy of event studies as a "midway position" that seemed to be a "substantial answer" to the "challenge [Halliburton] make[s] to the economic premises of the *Basic* decision." Justice Kennedy was skeptical of leaving *Basic* entirely intact. In an exchange with counsel for the Fund, Justice Kennedy remarked, "if later economic theories show that the market doesn't react in the way *Basic* assumed it automatically did, then certainly Congress would not wish to foreclose the Court from considering that new evidence if it was strong, clear and convincing, etc...."

Chief Justice Roberts, another potential swing vote, appeared to be undecided. Near the beginning of oral argument he asked Halliburton's counsel, "How am I supposed to review the economic literature and decide which of you is correct?" Halliburton's counsel responded by suggesting that "the Court should get out of the business of reviewing economic literature." Specifically addressing the Law Professors' position, the Chief Justice remarked, "I would think the event study they are talking

about would be a lot more difficult and laborious to demonstrate than market efficiency in a typical case."

"What difference does it make at what stage the rebuttal is allowed?"

-Justice Ginsburg

Justices Sotomayor, Kagan and Breyer appeared skeptical of requiring plaintiffs to prove price impact at the class certification stage. Justice Sotomayor remarked, "I don't see how this is a midpoint. If you're going to require proof of price impact, why not do away with market efficiency?" Justice Kagan added, "I just don't see how this splits the class at all because if you can't prove price impact, you can't prove loss causation and everyone's claims die." Justice Breyer questioned "what reason is there for purposes of certification to go beyond the efficient market?" However, Justice Breyer later appeared to warm to the idea of permitting defendants to rebut the presumption of reliance at the class certification stage by showing lack of price impact.

Justice Alito expressed reservations about *Basic*. Sparring with counsel for the Fund, Justice Alito asked, "Why should someone who purchased the stock…an hour or two after the disclosure, be entitled to recovery if in that particular market there is some lag time in incorporating the new information?"

"Once you get the class certified, the case is over, right?"

-Justice Scalia

Justice Ginsburg appeared to agree with the Fund's argument about the well-settled nature of *Basic*. "Whatever it might have been at the beginning, given the most recent legislation, Congress took a look at the 10(b)(5) action and it made a lot of changes…. It's difficult to say that this --- Congress would have legislated all these constraints if it thought there was no action to begin with." Justice Scalia disagreed: "[Congress] simply enacted a law that assumed that the courts were going to continue *Basic*. I don't see that [as] necessarily a ratification of it. It's just an acknowledgement of reality." Justice Scalia also underscored the difference between addressing the element of reliance at the class certification stage versus reserving it for later in the litigation. "Once you get the class certified, the case is over, right?" As counsel for Halliburton observed, "once the case gets past class certification…there is an in terrorem effect that requires defendants to settle even meritless claims."

Deputy Solicitor General Malcolm M. Stewart argued briefly on behalf of the United States in support of the Fund. In response to Justice Kennedy's question, the Deputy Solicitor General expressed the opinion that "the consequences" of adopting the Law Professors' view would not be "nearly so dramatic" as overturning *Basic* and, "if anything, that would be a net gain to plaintiffs, because plaintiffs already have to prove price impact at the end of the day."

IMPLICATIONS

If the Court Overturns Basic:

The Supreme Court will issue a decision in *Halliburton* by the end of June. If the Court overturns *Basic*, then the number of class action securities fraud lawsuits will be substantially reduced. But there still will be avenues for redress where securities fraud has been committed, including:

- Reliance on the *Affiliated Ute* Presumption. Plaintiffs may increasingly allege material omissions, rather than affirmative misstatements, in an effort to take advantage of the presumption of reliance established by the Supreme Court in *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128 (1972) (Blackmun, J.). Under *Affiliated Ute*, where there is "an omission of a material fact by one with a duty to disclose, the investor to whom the duty was owed need not provide specific proof

of reliance." *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008) (Kennedy, J.) (citing *Affiliated Ute*, 406 U.S. at 154). The *Affiliated Ute* presumption is based not on the fraud-on-the-market theory, but rather on the premise that "it is fair to force one who breached his duty to prove that the plaintiff did not so rely." *Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 385 (5th Cir. 2007) (Smith, J.). Importantly, plaintiffs are required to establish that defendants owed them a duty of disclosure in order to trigger the *Affiliate Ute* presumption.

- Claims Under Other Provisions of the Securities Laws. The *Basic* decision will not affect class action litigation asserting violations of other provisions of the securities laws that do not require proof of reliance, including Sections 11 and 12 of the Securities Act of 1933 and Section 14 of the Exchange Act.
- Individual Private Actions. The *Basic* decision will not prevent individual securities fraud actions under Section 10(b) to the extent the plaintiff can prove actual reliance on the alleged misstatement.
- SEC Enforcement Actions. The *Basic* decision will not disturb enforcement actions brought by the SEC because the SEC is not required to prove reliance. SEC enforcement activity could increase in the wake of a decision to overrule or substantially modify *Basic*.

If the Court Modifies Basic to Require Proof of Price Impact at Class Certification:

There is no consensus on how burdensome it would be for plaintiffs to prove at the class certification stage that the alleged misrepresentation impacted the price of a security. Halliburton's counsel observed at oral argument that "plaintiffs are commonly using event studies right now as part of their market efficiency showing." On the other hand, counsel for the Fund stated that in many cases showing price impact would be much more complicated than establishing market efficiency and would require extensive expert testimony. Recent scholarship similarly has noted that finding measurable price distortion is often difficult.[2] During oral argument, counsel for the Fund stated that class certification would become a fourth stage for filtering out claims, in addition to the motion to dismiss, motions for summary judgment and trial. If district courts conduct evidentiary hearings at the class certification stage requiring plaintiffs to demonstrate price impact, there could be increased scrutiny of plaintiffs' evidence and a decrease in the number of cases certified.

[2] *See* Langevoort, Judgment Day for Fraud-on-the-Market?: Reflections on Amgen and the Second Coming of Halliburton, Georgetown Public Law and Legal Theory Research Paper No. 13-058, http://ssrn.com/abstract=2281910 (Nov. 16, 2013).

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