June 24, 2014

Supreme Court Declines to Overrule or Modify *Basic*, But Allows Rebuttal of "Price Impact" in Opposing Class Certification

In *Halliburton Co.* v. *Erica P. John Fund, Inc.,* No. 13-317, the Supreme Court declined either to eliminate the fraud-on-the-market presumption established by *Basic Inc.* v. *Levinson*, 485 U.S. 224 (1988), or to modify *Basic* to require a plaintiff to prove that a defendant's misrepresentation affected the stock price (a showing known as "price impact") in order to invoke the presumption.[1] However, the Supreme Court clarified that *Basic* affords a defendant the opportunity to defeat the presumption at the class certification stage by introducing evidence of the absence of price impact. Although defendants will now have an opportunity to present economic defenses before being faced with the settlement pressures that they would face upon the certification of a class, it remains to be seen what lower courts will require to disprove price impact.

The Fraud-on-the-Market Presumption

The fraud-on-the-market theory has been a primary enabler of class action securities litigation under Section 10(b) of the Securities Exchange Act of 1934. One of the elements of a private right of action under Section 10(b) is that the plaintiff relied on the alleged misrepresentation in deciding whether to purchase or sell a security. Each putative class member's reliance would ordinarily require highly individualized proof, rendering class treatment unavailable. The fraud-on-the-market theory solves this problem for securities plaintiffs by creating a presumption of reliance if certain conditions are met.

First recognized by a four-justice majority in *Basic Inc.* v. *Levinson,* 485 U.S. 224 (1988), the fraud-on-the-market theory posits that if a company's security trades in an efficient market, a materially misleading statement by the company affects the security's price, thus affecting any person buying or selling the security. Therefore, under the theory, a purchaser or seller presumptively relies on any allegedly materially misleading statement by the company when it pays or receives the market price. Class members can thus plead reliance without regard to their individual awareness of the misleading statement. Cases against exchange-traded companies that could otherwise be brought only individually—an economically viable option only for the largest investors—can thus readily proceed as class actions.

The holding in *Basic* has come under heavy attack in recent years, charged with weak legal and economic underpinnings. Last year, four justices expressed their willingness to reconsider that decision in *Amgen*

[1] Paul, Weiss, Rifkind, Wharton & Garrison LLP represented the Securities Industry and Financial Markets Association as an amicus curiae in support of petitioners before the Supreme Court.

Inc. v. *Connecticut Retirement Plans & Trust Funds*, 133 S. Ct. 1184 (2013). The Court granted certiorari in *Halliburton* for just that purpose. The pendency of the case was a *cause célèbre* in the securities bar, eliciting nearly two dozen amicus briefs, leading litigants in lower court cases to seek discovery or trial delays, altering settlement negotiations, and dominating legal panel discussions. Amici supporting *Basic* urged that substantially modifying its rule "would essentially close the courthouse doors to victims of securities fraud . . . ."

The *Halliburton* Case

This is the second time that the *Halliburton* case has come before the Supreme Court. In 2002, Erica P. John Fund Inc. ("EPJ Fund") moved to certify a class of purchasers of Halliburton common stock. The District Court for the Northern District of Texas found that the proposed plaintiff class met the threshold requirements of Federal Rule of Civil Procedure 23(a), but denied the motion for class certification because EPJ Fund had failed to prove loss causation, or that any of Halliburton's alleged misrepresentations had caused the claimed economic losses. The requirement that plaintiffs in putative securities fraud class actions prove loss causation in order to obtain class certification was a unique prerequisite imposed by courts in the Fifth Circuit. The Court of Appeals for the Fifth Circuit affirmed the district court's denial of certification, and the Supreme Court granted EPJ Fund's petition for a writ of certiorari.

On June 6, 2011, in a 9-0 decision, the Supreme Court vacated the Fifth Circuit's ruling and remanded for proceedings consistent with its narrow holding that securities fraud plaintiffs need not prove loss causation in order to invoke *Basic*'s presumption of reliance and prevail on a motion for class certification. *Erica P. John Fund, Inc.* v. *Halliburton Co.*, 131 S. Ct. 2179 (2011).

On remand, Halliburton opposed class certification on the ground that the evidence it had previously introduced to disprove loss causation also proved that the alleged misrepresentations did not affect its stock price, and thus rebutted the *Basic* presumption. But the district court rejected that argument and certified the class. The Fifth Circuit affirmed on that ground and clarified that Halliburton could rely on evidence of the absence of price impact only at the merits stage of the litigation, and not before, because such evidence does not bear on the question of common issue predominance under Rule 23(b)(3).

The Supreme Court again granted certiorari, this time to resolve the split among the Circuits as to whether securities fraud defendants may rebut the *Basic* presumption with evidence of a lack of price impact at the class certification stage. It also agreed to reconsider the validity of the *Basic* presumption of class-wide reliance.

The *Halliburton* Decision

In an opinion by Chief Justice Roberts, joined by Justices Kennedy, Ginsburg, Breyer, Sotomayor, and Kagan, the Court vacated the Fifth Circuit's class certification order on the narrowest of the three grounds argued by Halliburton.

First, the Court rejected the invitation by Halliburton and its amici to overrule *Basic* outright, finding that there was no "special justification" for doing so. (Op. at 4-16.) The Court found that Congress's explicit requirement of reliance in Section 18(a) of the Exchange Act was not a special justification because that same argument had been presented to the *Basic* Court. (*Id*. at 7-8.) The Court also rejected the argument that advances in economic scholarship have discredited *Basic*'s underlying premises. The Court found that *Basic* did not rely on a "robust" efficient capital markets hypothesis or on the assumption that all investors rely on price integrity, but rather on the more "modest premise" that markets are "generally" efficient and the presumption that "most" investors rely on price integrity. (*Id*. at 8-12.)

The Court also found that the *Basic* presumption was a "substantive doctrine of federal securities-fraud law" entitled to the heightened level of stare decisis applicable to statutory interpretation cases. (*Id*. at 12-16.) The Court rejected Halliburton's argument that *Basic* was inconsistent with the line of cases calling for a narrow construction of the Section 10(b) implied right of action (*id*. at 13-14), and with recent decisions under Federal Rule of Civil Procedure 23 holding that the requirements of class certification must be proven, not pleaded (*id*. at 14-15). And the Court found that the arguments about the "serious and harmful consequences" of securities class actions were "more appropriately addressed to Congress," which has demonstrated a willingness to consider such concerns in the Private Securities Litigation Reform Act of 1995 and the Securities Litigation Uniform Standards Act of 1998. (*Id*. at 15-16.)

Second, the Court rejected Halliburton's first alternative argument that *Basic* should be modified to require plaintiffs to prove price impact in order to invoke the presumption of reliance. (*Id*. at 16-18.) The Court found that this alternative, "[f]ar from [being] a modest refinement of the *Basic* presumption, . . . would radically alter the required showing for the reliance element of the Rule 10b-5 cause of action." (*Id*. at 17.) Such an alternative would deprive plaintiffs of the first of *Basic*'s "two constituent presumptions": (i) the presumption that a public, material misrepresentation in a generally efficient market affects the stock price; and (ii) the presumption that a plaintiff who purchases at the market price during the relevant period purchased in reliance upon the misrepresentation. (*Id*. at 17-18.) For the same reasons that the Court declined to "completely jettison the *Basic* presumption," it declined to "effectively jettison half of it by revising the prerequisites for invoking it." (*Id*. at 18.)

Third, the Court accepted Halliburton's second alternative argument that "defendants should at least be allowed to defeat the presumption at the class certification stage through evidence that the misrepresentation did not in fact affect the stock price." (*Id*. at 18-23.) It was common ground that defendants could present such evidence at trial, on a motion for summary judgment, or in opposition to a motion for class certification as evidence that the market in question is not efficient. (*Id.* at 18-19.) Importantly, *Halliburton* holds that defendants also may introduce, at the class certification stage, evidence of a lack of price impact as to the specific alleged misrepresentations, rather than confining price impact evidence to the question of whether the relevant market is generally efficient.

As the Court explained: "Price impact is . . . an essential precondition for any Rule 10b-5 class action. While *Basic* allows plaintiffs to establish that precondition indirectly, it does not require courts to ignore a defendant's direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock's market price and, consequently, that the *Basic* presumption does not apply." (*Id.* at 21.) "[T]o maintain the consistency of the [*Basic* fraud-on-the-market] presumption with the class certification requirements of Federal Rule of Civil Procedure 23, defendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock." (*Id.* at 23.)

In a brief concurrence, Justice Ginsburg, joined by Justices Breyer and Sotomayor, noted that the majority's opinion, because it placed the burden of disproving price impact on defendants, "should impose no heavy toll on securities-fraud plaintiffs with tenable claims." (Ginsburg Concurrence at 1.)

In a more lengthy opinion concurring in the judgment, Justice Thomas, joined by Justices Scalia and Alito, argued that *Basic* should be overruled because "[l]ogic, economic realities, and our subsequent jurisprudence have undermined the foundations of the *Basic* presumption." (Thomas Concurrence at 2.)

Implications

With only three justices voting to overrule *Basic*, and with the six-justice majority also declining to modify *Basic* to require the plaintiff to carry the burden of proving price impact at the class certification stage, it is clear that—barring congressional legislation or a change in the composition of the Court—securities class actions are here to stay. In securities cases, the Court is likely to continue to move incrementally, rather than adopting sweeping changes in a single case, as suggested by the narrow issues that it will consider next term in *Omnicare, Inc.* v. *Laborers District Council Construction Industry Pension Fund*, No. 13-435 (whether a statement of opinion must be subjectively false rather than merely objectively wrong to establish a violation of the Securities Act of 1933), and *Public Employees' Retirement System* v. *IndyMac MBS*, *Inc.* No. 13-640 (whether the filing of a putative class action tolls the three-year statute of repose in Section 13 of the Securities Act of 1933 with respect to the claims of class members).

First, it is not yet clear how often defendants will be successful in defeating class certification by carrying the burden of disproving price impact, as *Halliburton* now permits them to do. Although some circuits—including the Second Circuit—already had suggested that defendants might disprove price impact at that stage, *see In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 484-85 (2d Cir. 2008); *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 638 (3d Cir. 2011), the Supreme Court's explicit recognition of this defense may encourage what has, until now, been a strategy of limited application. *Halliburton*'s price impact rebuttal—conceptually distinct from disproof of materiality—thus remains largely unexplored. Rebutting price impact will inevitably become a battle of the experts, and developing the requisite expert support early in a case may well prove outcome determinative. Even if defendants fail to defeat class certification, the expert's analysis may assist the defendants in seeking summary judgment, on a more developed record, as to materiality or loss causation.

As a practical matter, defendants' ability to defeat class certification will depend on what lower courts will require to disprove price impact. Plaintiffs will likely argue that lack of price impact cannot be proven when there is evidence of a price decline at the time of corrective disclosure. Defendants, by contrast, may argue that an absence of price movement at the time of the alleged misstatements disproves price impact in many cases, notwithstanding a price decline at the time of corrective disclosure. In the event a defendant successfully proves lack of price impact with respect to certain alleged misstatements but not others, it may be able to challenge the length of the class period. There will be a period in which the courts need to set the parameters as to how defendants can rebut price impact, and the parties adjust their strategies accordingly.

Second, it remains an open question whether defendants' potential rebuttals of the *Basic* presumption at the class certification stage will be limited to a lack of price impact or extended to "[a]ny showing that severs the link" between the misrepresentation and the transaction price. (Op. at 20 (quoting *Basic*, 485 U.S. at 248).) For example, defendants may wish to rebut *Basic*'s second "constituent premise"—i.e., that "most investors" in a given security relied on price integrity. (*See* Op. at 11-12, 17-18.) As with price impact, it could be argued that "an indirect proxy should not preclude direct evidence when such evidence is available." (*Id.* at 20.) *Halliburton* opens the door to such defenses by rejecting, albeit sub silentio, the dicta in the final footnote of the *Basic* majority that "[p]roof of that sort is a matter for trial." *Basic*, 485 U.S. at 249 n.29.

Third, the Court noted in particular that a defendant could defeat the fraud on the market theory by showing "that a plaintiff would have bought or sold the stock even had he been aware that the stock's price was tainted by fraud . . . ." (Op. at 7.) This may provide defendants an argument for challenging the adequacy of proposed class representatives whose trading practices do not rely on public disclosures, such as index funds.

Fourth, if the price impact rebuttal authorized by *Halliburton* gains meaningful traction, plaintiffs may seek refuge in other presumptions of reliance, for example by re-casting misstatements as omissions. *See Affiliated Ute Citizens* v. *United States*, 406 U.S. 128, 153-54 (1972). Whether the *Affiliated Ute* doctrine can accommodate such cases, and whether a *Halliburton*-like rebuttal is available under *Affiliated Ute*, remain open questions.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Susanna M. Buergel (212) 373-3553 sbuergel@paulweiss.com	Charles E. Davidow (202) 223-7380 cdavidow@paulweiss.com	Brad S. Karp (212) 373-3316 bkarp@paulweiss.com
Daniel J. Kramer (212) 373-3020 dkramer@paulweiss.com	Jane B. O'Brien (202) 223-7327 jobrien@paulweiss.com	Richard A. Rosen (212) 373-3305 rrosen@paulweiss.com
Audra J. Soloway (212) 373-3289 asoloway@paulweiss.com		

**Associates Shane D. Avidan and Brette Tannenbaum contributed to this memo.*