

The *Basics* of Obtaining Class Certification in Securities Fraud Cases: U.S. Supreme Court Clarifies Standard, Rejecting Fifth Circuit's "Loss Causation" Requirement

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In its June 6, 2011 decision in *Erica P. John Fund, Inc. v. Halliburton Co.*,¹ the U.S. Supreme Court clarified the standard for plaintiffs in securities fraud cases to obtain class certification (which allows their claims to proceed collectively). The Court unanimously rejected the Fifth Circuit's requirement that, to prevail at the class certification stage, plaintiffs asserting claims under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act) and Rule 10b-5 thereunder for alleged misrepresentations in connection with the purchase or sale of a security must prove the element of loss causation, "a causal connection between the material misrepresentation and the loss."² While the Supreme Court's ruling does not significantly alter the legal landscape surrounding securities class actions, as numerous lower federal courts—including the Second, Third, and Seventh Circuit Courts of Appeals—had rejected the Fifth Circuit standard,³ the decision relieves plaintiffs within the Fifth Circuit of a formidable burden and precludes other courts from adopting that approach. The decision also reaffirms the principles the Supreme Court endorsed more than two decades ago in *Basic Inc. v. Levinson*,⁴ in which the Court held plaintiffs could demonstrate the Section 10(b) element of reliance—that they relied on the alleged misrepresentations in deciding to purchase or sell the subject security—on a classwide basis by invoking the "fraud-on-the-market" presumption.

A general understanding of (1) the class certification requirements under Rule 23 of the Federal Rules of Civil Procedure, (2) the rationale animating the fraud-on-the-market presumption, and (3) the Fifth Circuit's now-defunct standard is necessary to appreciate the meaning and import of the Supreme Court's ruling in *Halliburton*. A summary of those issues follows.

Rule 23 permits class certification in a securities fraud case where the court finds, among other things, common questions of law or fact "predominate" over individual issues.

Plaintiffs in securities fraud cases may obtain class certification under Rule 23(b)(3) where the court finds, among other things, "the questions of law or fact common to class members predominate over any questions affecting only individual members." With respect to a claim under Section 10(b) of the Exchange Act (and Rule 10b-5), the "predominance" inquiry turns on showing that class members will rely on common proof at trial to establish the elements of the claim: (1) defendant's misrepresentation or omission of a material fact; (2) scienter, "a wrongful state of mind"; (3) a connection with the purchase or sale of a security; (4) reliance, often referred to in cases premised on securities traded in public markets as "transaction causation"; (5) economic loss; and (6) loss causation.⁵

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The susceptibility of class treatment as to most of the Section 10(b) criteria usually does not engender much controversy. But where debates do arise, they typically center on reliance—specifically, whether plaintiffs can establish the applicability of the “fraud-on-the-market” presumption, which affords the class a rebuttable presumption of reliance on the alleged misrepresentations.⁶ As the Supreme Court recognized in *Basic*, without the presumption, plaintiffs seeking class status would encounter significant difficulty meeting Rule 23’s predominance threshold.⁷

The *Basic* presumption of reliance helps securities fraud plaintiffs establish predominance.

In *Basic*, the Supreme Court recognized a rebuttable presumption of reliance based on the fraud-on-the-market theory, declaring: “An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in market price, an investor’s reliance on any public material misrepresentations, therefore, may be presumed for purposes of a *Rule 10b-5* action.”⁸ The Court’s rationale in accepting the presumption drew largely from the features of “modern securities markets,” which warrant treating investors’ reliance on securities traded in those markets differently than in traditional “face-to-face transactions.”⁹

Plaintiffs in *Basic* asserted that defendants violated Section 10(b) by making material misrepresentations to investors about a proposed merger transaction, creating a “depressed” market for Basic stock, and plaintiffs sold their shares in reliance on those misrepresentations.¹⁰ Both the district court, in granting class certification, and the Sixth Circuit Court of Appeals, in upholding the lower court’s determination, endorsed the fraud-on-the-market presumption as a means for plaintiffs to establish common reliance, allowing them to meet Rule 23’s predominance requirement.

On appeal of the Sixth Circuit’s decision, the Supreme Court identified several factors supporting adoption of the fraud-on-the-market presumption, including that class plaintiffs otherwise faced a significant hurdle to demonstrating predominance.¹¹ The Court also articulated an analytical justification for the presumption, explaining that unlike in face-to-face transactions, “[w]ith the presence of a market, the market is interposed between seller and buyer and, ideally, transmits information to the investor in the processed form of a market price.”¹² The market thus “is acting as the unpaid agent of the investor, informing him that given all the information available to it, the value of the stock is worth the market price.”¹³ The Court reasoned that in light of the realities of open-market securities transactions, requiring a plaintiff “to show . . . how he would have acted if omitted material information had been disclosed” or “if the misrepresentation had not been made” would “place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market.”¹⁴

While the *Basic* presumption protects investors against defendants’ class certification attack on reliance grounds, the presumption is not impenetrable. Defendants can rebut it with “[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.”¹⁵ But the Supreme Court in *Basic* did not specify at which phase in the litigation—class certification, summary judgment, trial, or another time—a court should entertain defendants’ rebuttal arguments.¹⁶

The Sixth Circuit had held that to invoke the fraud-on-the-market presumption, a plaintiff must “allege and prove”: (1) defendant made public misrepresentations; (2) the misrepresentations were material; (3) the security traded on an “efficient” market; (4) the misrepresentations “would induce a reasonable, relying investor to misjudge the value” of the security; and (5) plaintiff traded the security be-

tween the time of the misrepresentations and when “the truth” emerged.¹⁷ While the Supreme Court did not elaborate on those factors,¹⁸ it indicated the presumption could lie only where the market for a security is “impersonal” and “well-developed” (or “open and developed”) and the security price reflects “most publicly available information”¹⁹—attributes bearing on what courts have termed “market efficiency.” The Court did not suggest an absence of loss causation could rebut, or fail to raise, the presumption. Indeed, the issue of loss causation appears nowhere in *Basic*.

The Fifth Circuit imported loss causation, an element of Section 10(b) distinct from reliance, into the fraud-on-the-market analysis.

Market efficiency is the analytical engine driving the fraud-on-the-market presumption.²⁰ Among the numerous factors courts typically consider in determining whether a market was efficient during the relevant period, one indicator of efficiency—the causal relationship between company-specific disclosures and a prompt response in stock price—stands as “the most important.”²¹ The Fifth Circuit homed in on that factor in developing a severe standard for plaintiffs seeking class certification. In addition to showing defendant made public material misrepresentations, defendant’s shares were traded in an efficient market, and plaintiffs traded shares between the time defendant made the misrepresentations and when the truth came out, plaintiffs had to prove the alleged misrepresentations “‘actually moved the market,’” that is, loss causation.²²

The loss causation inquiry entails an examination of whether investors suffered losses once the revelation of the “truth” concealed by the alleged misrepresentations ultimately emerged; the relevant question thus is “whether a particular misstatement *actually* resulted in loss.”²³ While courts have expressed the differences between reliance and loss causation and generally resist conflating those sep-

arate elements of the Section 10(b) claim, the Fifth Circuit merged them.

Under the Fifth Circuit standard, plaintiffs could prove loss causation by demonstrating either “an increase in stock price immediately following the release of positive information” or “negative movement in the stock price after release of the alleged ‘truth’ of the earlier falsehood.”²⁴ Where, as in *Halliburton*, plaintiff took the latter course, plaintiff needed to prove “that its loss resulted directly *because* of the correction to a prior misleading statement; otherwise there would be no inference raised that the original, allegedly false statement caused an inflation in the price to begin with.”²⁵ In that vein, if a company released “multiple items of negative information on the same day,” plaintiff bore the onus to “establish a reasonable likelihood that a subsequent decline in stock price [was] due to the revelation of the truth of the earlier misstatement rather than to the release of the unrelated negative information,” thereby “satisfy[ing] the court that [plaintiff’s] loss likely resulted from the specific correction of the fraud and not because of some independent reason.”²⁶

In *Halliburton*, both the district court and the Fifth Circuit held plaintiff (on behalf of itself and the putative class) did not satisfy the loss causation standard. Plaintiff claimed Halliburton made false statements between June 3, 1999 and December 7, 2001 concerning the scope of its potential liability in asbestos litigation, its expected revenue from certain construction contracts, and the benefits of its merger with Dresser Industries. Plaintiff’s Section 10(b) claims against Halliburton and its CEO David Lesar (together, Halliburton) survived defendants’ motion to dismiss. The district court later denied class certification, however, solely on the basis of plaintiff’s failure to prove loss causation, which precluded a finding of predominance under Rule 23(b)(3).²⁷ Noting the Fifth Circuit had placed “an extremely high burden on plaintiffs seeking class certification in a securities fraud case,” the district court rejected plaintiff’s arguments that several

“corrective disclosures” revealed prior misrepresentations by Halliburton.²⁸ Therefore, notwithstanding that Halliburton had *conceded market efficiency*, the court ruled plaintiff could not invoke the fraud-on-the-market presumption.²⁹

On appeal, the Fifth Circuit upheld the lower court’s determinations. Emphasizing that the loss causation showing entails “a ‘rigorous process’ and requires both expert testimony and analytical research or an event study that demonstrates a linkage between the *culpable* disclosure and the stock-price movement,” the Court of Appeals held plaintiff, who relied primarily on expert analysis, did not carry its burden.³⁰

The Supreme Court rejected the Fifth Circuit’s loss causation requirement, reaffirming the principles espoused in *Basic*.

In its recent decision in *Halliburton*, the Supreme Court held plaintiffs need not prove loss causation to trigger the fraud-on-the-market presumption at the class certification stage. The Court explained loss causation “addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock.”³¹ Distinct from reliance, which typically addresses “facts surrounding the investor’s decision to engage in the transaction,” loss causation “requires a plaintiff to show that a misrepresentation that affected the integrity of the market price *also* caused a subsequent economic loss.”³² Given that analytical difference, the Fifth Circuit’s rule “contra-vene[d] *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.”³³

The Supreme Court also dispensed with Halliburton’s “wishful” contention that, while securities fraud plaintiffs indeed should not be required to prove loss causation to invoke the *Basic* presumption, the Fifth Circuit “did not actually require plaintiffs to prove ‘loss causation’ as we have used that

term.”³⁴ Halliburton insisted the Court of Appeals used “loss causation” merely as “‘shorthand’ for a different analysis”: whether plaintiff “had demonstrated ‘price impact’—that is, whether the alleged misrepresentations affected the market price in the first place.”³⁵ Halliburton posited “that 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.”³⁶ Rejecting Halliburton’s characterization of the Fifth Circuit standard, the Supreme Court explained loss causation and price impact are distinct concepts and highlighted the “repeated and explicit references to ‘loss causation’” in the Fifth Circuit’s decision.³⁷

The Supreme Court’s rejection of Halliburton’s “price impact” argument is significant. Had the Court equated loss causation and price impact, not only could a different ruling have resulted, the decision also likely would have had broader implications for securities litigation. Furthermore, the Court declined to address the merits of Halliburton’s related assertion that “a plaintiff must prove price impact . . . after *Basic*’s presumption has been successfully rebutted by the defendant.”³⁸ The parties had devoted substantial attention to whether defendants may rebut the *Basic* presumption at the class certification stage (plaintiff arguing no, Halliburton arguing the contrary). That issue already had spawned conflict among the Courts of Appeals, with the Second and Third Circuits allowing for rebuttal at class certification and the Seventh Circuit precluding it. But the Supreme Court expressly did not “address any other question about *Basic*” besides the loss causation issue, including “how and when” the presumption may be rebutted.³⁹

What the Supreme Court did not say in *Halliburton* thus perhaps is as notable as what it actually held. While disapproving the Fifth Circuit’s use of loss causation as a prerequisite to class certification, the Court left the door open for controversies over rebutting the fraud-on-the-market presumption, how far courts may probe the merits of a case in evaluat-

ing whether Rule 23's elements are met, and the requirements for demonstrating loss causation on the merits—all issues raised by the parties in *Halliburton* but, for now, left unresolved by the Court.

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1 No. 09-01403, 2011 BL 147880 (U.S. June 6, 2011).

2 *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 342 (2005).

3 See *In re DVI, Inc. Sec. Litig.*, No. 08-08033, 2011 BL 82497, at *25-28 (3d Cir. Mar. 29, 2011); *Schleicher v. Wendt*, 618 F.3d 679, 687 (7th Cir. 2010); *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 483 (2d Cir. 2008).

4 485 U.S. 224 (1988).

5 See *Dura*, 544 U.S. at 341-42.

6 A “rebuttable presumption,” such as the fraud-on-the-market presumption, is “[a]n inference drawn from certain facts that establish a prima facie case, which may be overcome by the introduction of contrary evidence.” BLACK’S LAW DICTIONARY 1024 (abr. 9th ed. 2010).

7 See *Basic*, 485 U.S. at 242 (“Requiring proof of individualized reliance from each member of the proposed plaintiff class effectively would have prevented [the named plaintiffs] from proceeding with a class action, since individual issues then would have overwhelmed the common ones.”).

8 *Id.* at 247.

9 *Id.* at 243-44.

10 *Id.* at 228, 242.

11 See *supra* note 7.

12 *Id.* at 244 (citation and internal quotation marks omitted).

13 *Id.* (citation and internal quotation marks omitted).

14 *Id.* at 245. The Court also found the presumption “is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the [Exchange] Act” and noted the general acceptance of the fraud-on-the-market theory by courts considering it, as well as by commentators. *Id.* at 245-47.

15 *Id.* at 248.

16 Noting, however, the possible “incongruity” between assuming Basic shares were “traded on a well-developed, efficient, and information-hungry market” and alleging “that such a market could remain misinformed, and its valuation of Basic shares depressed, for 14 months, on the basis of the three public statements” at issue in the case, the Court stated “[p]roof of that sort is a matter for trial.” *Id.* at 249 n.29 (emphasis added).

17 *Id.* at 248 n.27.

18 In *Halliburton*, the Supreme Court observed: “It is undisputed that securities fraud plaintiffs must prove certain things in order to invoke *Basic*’s rebuttable presumption of reliance. It is common ground, 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.’” 2011 BL 147880, at *5-6 (quoting *Basic*, 485 U.S. at 248 n.27; also citing *Basic, supra*, at 241-47, and *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 552 U.S. 148, 159 (2008)).

19 *Basic*, 485 U.S. at 247. An “open” market “is one in which anyone, or at least a large number of persons, can buy or sell.” *Freeman v. Laventhol & Horwath*, 915 F.2d 193, 198 (6th Cir. 1990) (citation and internal quotation marks omitted). A “developed” market “is one which has a relatively high level of activity and frequency, and for which trading information (e.g., price and volume) is widely available.” *Id.* at 198-99 (citation and internal quotation marks omitted).

20 See, e.g., *Schleicher*, 618 F.3d at 688 (“The district court assured itself that the market for Consec’s stock was thick enough to transmit defendants’ statements to investors by way of the price. That finding supports use of the fraud-on-the-market doctrine as a replacement for individual reading and reliance on defendants’ statements.”).

21 *In re Xcelera.com Sec. Litig.*, 430 F.3d 503, 512 (1st Cir. 2005).

22 *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330, 335 (5th Cir. 2010) (quoting *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 265 (5th Cir. 2007)), *vacated and remanded sub nom. by Erica P. John Fund, Inc. v. Halliburton Co.*, 2011 BL 147880, *supra*.

23 *Miller v. Thane Int’l, Inc.*, 615 F.3d 1095, 1102 (9th Cir. 2010).

24 *Halliburton*, 597 F.3d at 335.

25 *Id.* at 336.

26 *Id.*

27 *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, No. 02-CV-01152, 2008 BL 249653, at *1 (N.D. Tex. Nov. 4, 2008), *aff'd*, 597 F.3d 330 (5th Cir. 2010), *vacated and remanded by Halliburton*, 2011 BL 147880, *supra*.

28 *Id.* at *37.

29 *Id.* at *2, *37.

30 *Halliburton*, 597 F.3d at 339-44 (citation and internal quotation marks omitted).

31 *Halliburton*, 2011 BL 147880, at *6.

32 *Id.* at *6-7.

33 *Id.* at *7.

34 *Id.* at *8-9.

35 *Id.* at *8 (quoting Resp'ts' Br. 18).

36 *Id.* at *8-9.

37 *Id.* at *9.

38 *Id.* at *10 n.*.

39 *Id.* at *9.