Supreme Court to Revisit the Fraud-on-the-Market Presumption of Reliance in Securities Fraud Case

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In November 2013, the United States Supreme Court agreed to hear a corporate defendant's sweeping challenge to the fraud-on-the-market presumption of reliance in securities fraud cases. Reliance is a necessary element of a securities fraud claim. The fraud-on-the-market theory—as articulated in the 1988 Supreme Court case, *Basic Inc. v. Levinson*[2]—permits plaintiffs to demonstrate class-wide reliance in that it presumes that when a security is traded in an efficient market, all publicly available material information, including a defendant's publicly made fraudulent statements, is reflected in the market price.

While predicting how the Supreme Court will rule is always a guessing game, the Court's recent whittling down of class action availability to investors in securities fraud cases is instructive, and may well signal a coming decision that is neither all nor nothing, but rather something in the middle.

The case is *Erica P. John Fund, Inc. v. Halliburton Co., et al.*, No. 13-317 (U.S.), a class action brought by the Archdiocese of Milwaukee Supporting Fund, Inc., today known as the Erica P. John Fund, Inc. ("Plaintiff"), against the Halliburton Company ("Halliburton") and its former president and chief operating officer for violations of Section 10(b) of the Securities Exchange Act of 1934[3] (the "Exchange Act") and SEC Rule 10b-5.[4] Halliburton last year petitioned the Supreme Court for review, urging the Court to overrule *Basic* or, in the alternative, modify its decision in that case so as to require securities fraud plaintiffs to prove price impact at class certification in order to invoke the fraud-on-the-market presumption of reliance. Halliburton's core argument is that the economic rationale underlying the 1988 decision is outdated and invalid in light of the evolution of the theory of market efficiency since that time.

First filed in 2002, this case now returns to the Supreme Court for the second time. On the case's first trip to the high court in 2011[5]—after the lower courts' class certification denial—Plaintiff sought review and the Court held, in a unanimous opinion by Chief Justice Roberts, that securities fraud plaintiffs need not prove loss causation at class certification in order to avail themselves of the fraud-on-the-market presumption established in *Basic*.[6]

Now the case is once again set for oral argument before the Supreme Court—this time on Halliburton's petition—after the lower courts changed course following the Court's first decision, granting class certification on remand. Just prior to the most recent oral argument in the Fifth Circuit on this case, the Supreme Court held 6-3 in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*[7] that securities fraud plaintiffs need not establish that misrepresentations were material in order to avail themselves of *Basic*'s presumption of reliance for purposes of class certification.[8] Four justices in that case, however, signaled their willingness to reconsider that presumption: Justice Alito in his concurrence[9] and Justice Thomas in a dissent joined by Justices Scalia and Kennedy.[10]

What will the Court do? There are essentially three potential scenarios, some more likely than others. First, the Court could fully embrace Halliburton's assault on the fraud-on-the-market presumption and overrule *Basic*. This seems the least likely scenario. After all, *Basic* has remained good law for over 25 years and the Court itself has repeatedly endorsed—in several cases decided since that time—the fraud-on-the-market presumption, including in its unanimous opinion in this case in 2011.[11] What's more, the presumption is rebuttable by defendants.

Second, the Court could reject Halliburton's arguments and leave the law as it stands today, retaining *Basic*'s presumption of reliance being available to plaintiffs in securities fraud class actions without proof at the class certification stage. In its opposition brief in *Halliburton*, Plaintiff notes that the adoption of the fraud-on-the-market presumption is based principally upon Congressional policy underlying the adoption of the Exchange Act and not economic theory (as Halliburton contends). The Court itself in *Amgen* recognized that while Congress has amended the federal securities laws a few times since 1988, it has never legislatively overruled *Basic*—although it had the opportunity to do so when enacting, for instance, the Private Securities Litigation Reform Act in 1995 and the Securities Litigation Uniform Standard Act of 1998—and, in fact, has rejected a proposed act that "would have undone *Basic*."[12] Moreover, Plaintiff correctly points out that, even though the consideration of economic theory is secondary when considering the Court's rationale in *Basic*, the semi-efficient market hypothesis is still widely supported among economists today. Indeed, Halliburton itself had conceded that its stock traded on an efficient market,[13] yet did not challenge *Basic* until almost two years after the Supreme Court's original reversal of the Fifth Circuit in 2011.

Third—and what seems most likely given its consistent decisions in recent years to place new hurdles before investors in securities class actions—the Court may find a middle ground by not overruling *Basic* but instead requiring some proof that the misrepresentations affected market price at the class certification stage—perhaps in the context of the Rule 23(a)(2) "commonality" analysis[14]—in order to invoke the fraud-on-the-market presumption. That prediction is based upon the Roberts' Court's apparent hostility to securities class actions, beginning with a trio of 10(b)-related decisions: *Dura Pharmaceuticals, Inc. v. Broudo*[15] in 2005, which limited loss causation; *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*[16] in 2007, which heightened pleading requirements; and *Stoneridge Investment Partners, LLC v. Scientific-Atlantic, Inc.*[17] in 2008, which rejected the theory of "scheme liability" with respect to third parties alleged to have aided and abetted a securities fraud.

Such a middle-ground approach would shift the burden at class certification to plaintiffs to prove market efficiency in order to be entitled to a presumption of reliance. In this scenario, the Court would likely hold that the effect of a misrepresentation on the trading price of a security is properly analyzed at class certification in order for a plaintiff to show that common issues predominate for Rule 23 purposes. Thus, showing market efficiency would likely require more limited discovery at the class certification stage in order for plaintiffs to affirmatively show that corrective disclosures were the reason for a drop in stock price. If the Court does rule in this way—or sets up some other middle-ground legal construct between overruling and reaffirming—this case would merely become the next decision of this Court to make class action availability more challenging for defrauded investors seeking relief.

Oral argument in the case is scheduled for March 5. A decision is expected by the end of the Court's term in late June.

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2 485 U.S. 224 (1988).

3 15 U.S.C. § 78j(b).

4 17 C.F.R. 240.10b-5.

5 *Erica P. John Fund., Inc. v. Halliburton Co., et al.*, 131 S. Ct. 2179 (2011).

6 *Id.* at 2183.

7 133 S. Ct. 1184.

8 *Id.* at 1191.

9 *Id.* at 1204.

10 *Id.* at 1206.

11 *Halliburton*, 131 S. Ct. at 2181-82.

12 133 S. Ct. at 1201.

13 *Halliburton*, 131 S. Ct. at 2182.

14 Fed. R. Civ. P. 23(a)(2).

15 543 U.S. 1134 (2005).

16 551 U.S. 308 (2007).

17 552 U.S. 148 (2008).

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