VII. Securities Fraud Class Actions: Courts to Consider Price Impact Evidence at Class Certification Stage

A. Introduction

On June 23, 2014, the Supreme Court in *Halliburton Co. v. Erica P. John Fund, Inc.* ("*Halliburton II*") decided not to overrule *Basic Inc. v. Levinson*'s[1] presumption of common reliance in securities fraud class actions.[2] However, the Court recognized the defendants' ability to directly rebut the *Basic* presumption of reliance at the class certification stage.[3] Commentators and experts disagree about the possible consequences of this new ability on future class action security suits. Some suggest that defendants will settle less often considering their additional ammunition.[4] Others point out that plaintiffs might less frequently pursue their securities fraud claims given the higher and earlier costs of proving reliance.[5]

This Article explores these questions and proceeds as follows. First, this Article outlines *Halliburton II*'s background. Part B provides the facts, statutes, and issues involved in *Halliburton II*. Part C discusses the *Basic* decision. Part D discusses the parties' arguments in

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[1] 485 U.S. 224 (1988).

[2] Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398, 2410 (2014).

[3] *Id.* at 2417.

[4] *See* Jess Bravin & Brent Kendall, *Firms Get More Leeway To Block Investor Suits*, WALL ST. J., June 24, 2014, at C1 ("[C]orporate defendants are entitled to rebut the presumption investors relied on company statements before a plaintiff class action is certified by a trial court—a step companies say puts pressure on them to settle even questionable claims rather than risk a jury verdict.").

[5] Owen C. Pell et al., Halliburton Co. v. Erica P. John Fund, Inc.*: The US Supreme Court Confirms that Defendants in Securities Fraud Cases May Rebut Alleged Price Impact at the Class Certification Phase*, WHITE & CASE LLP, 3 (June 2014), http://www.whitecase.com/files/Publication/1bed4b15-f279-4a90-8fb5-2feaeece40ab/Presentation/PublicationAttachment/d27d7e0a-6d6f-4e2b-aeff-3da55e35cebc/wc-alert-haliburton-litigation.pdf, *archived at* http://perma.cc/G2S5-42LE ("Given that most securities class action cases are handled on a contingent-fee basis, with plaintiffs' counsel only receiving payment upon some recovery or settlement, the front-loading of expert and other fees needed to justify class certification is likely to make plaintiffs' counsel choose more carefully which securities cases to bring—and may continue the recent trend of fewer securities fraud cases being filed.").

Halliburton II. Part E analyzes *Halliburton II*'s majority opinion. Part F analyzes *Halliburton II*'s concurring opinions. Part G considers the potential consequences of the *Halliburton II* decision. Finally, Part H draws conclusions on the future of class action securities suits.

B. *Halliburton II*: Background

The lead plaintiff, the Erica P. John Fund ("Fund"), alleged that the defendant, Halliburton Co., attempted to inflate its stock price when it "made a series of misrepresentations regarding its potential liability in asbestos litigation, its expected revenue from certain construction contracts, and the anticipated benefits of its merger with another company."[6] The EPJ Fund contended that Halliburton depressed its stock price, harming investors, when it later issued corrective disclosures regarding those misrepresentations.[7]

The EPJ Fund alleged that Halliburton's misrepresentations violated Section 10(b) of the Securities Exchange Act of 1934[8] and Securities and Exchange Commission Rule 10b–5.[9] Under Section 10(b) of the Securities and Exchange Act, investors can bring private suits against companies that allegedly defrauded investors with regard to securities trading.[10] To succeed on a Section 10(b) claim, the "plaintiff must prove '(1) a material misrepresentation or omission by the defendant; (2) scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.'"[11] In *Halliburton II*, the Court focuses on the element of reliance.[12] The reliance element of this test is necessary to establish a connection between the plaintiff's injury and the defendant's misrepresentation.[13]

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[6] *Halliburton*, 134 S. Ct. at 2405.
[7] *Id.* at 2405–06.
[8] Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (2012).
[9] *Halliburton*, 134 S. Ct. at 2405; 17 C.F.R. § 240.10b–5 (2014).
[10] 15 U.S.C. § 78j(b); *Halliburton*, 134 S. Ct. at 2407.
[11] *Halliburton*, 134 S. Ct. at 2407 (internal quotation marks omitted) (quoting Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1192 (2013)).
[12] *See id.* at 2405.
[13] Erica P. John Fund, Inc. v. Halliburton Co., 131 S. Ct. 2179, 2184–85 (2011) (citing Basic Inc. v. Levinson, 485 U.S. 224, 243 (1988)).

To certify a class, plaintiffs must satisfy the requirements of Rule 23 of the Federal Rules of Civil Procedure.[14] Of particular concern in *Halliburton II*, Rule 23(b)(3) requires that "questions of law or fact common to class members predominate over any questions affecting only individual members."[15] This requirement often depends on the plaintiffs' satisfying the reliance element of a securities fraud claim.[16]

The Supreme Court dealt with two particular issues in *Halliburton II*.[17] First, the Court analyzed *Basic Inc. v. Levinson*'s presumption of reliance and considered whether it should be overruled or changed.[18] Second, the Court considered whether Halliburton could present direct evidence of a lack of price impact at the class certification stage and thereby rebut the *Basic* presumption.[19]

C. The *Basic* Decision

In *Basic*, the defendant, Basic, Inc., released three statements from 1977 to 1978 denying that it was negotiating a merger with another company, Combustion Engineering, Inc.[20] On December 18, 1978, Basic released a statement that another company had "approached" it seeking a merger.[21] Over the next two days, Basic endorsed and publicly approved Combustion's offer for all of Basic's outstanding shares.[22] Plaintiffs, who sold their stock after Basic released the statements denying that there were ongoing merger negotiations, filed a suit alleging that Basic's statements violated Section 10(b) and Rule 10b–5.[23]

The Supreme Court in *Basic* held that the plaintiff could invoke a presumption of reliance on misleading statements if the plaintiff could show (1) that the misleading statements were material, (2) that the misleading statements were publicly known, "(3) that the stock traded in an efficient market, and (4) that the plaintiff traded the

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[14] FED. R. CIV. P. 23.
[15] FED. R. CIV. P. 23(b)(3).
[16] *Erica P. John Fund*, 131 S. Ct. at 2184.
[17] *Halliburton*, 134 S. Ct. at 2405.
[18] *Id.*
[19] *Id.*
[20] Basic Inc. v. Levinson, 485 U.S. 224, 227 (1988).
[21] *Id.* at 227–28.
[22] *Id.* at 228.
[23] *Id.*

stock between the time the misrepresentations were made and when the truth was revealed."[24]

The Court in *Basic* based this presumption on the "fraud-on-the-market" theory.[25] The fraud-on-the-market theory suggests that in an efficient market, available, material information regarding a company determines that company's stock price.[26] Given that investors rely on that market price's integrity, the Court can presume that the investors necessarily relied on the misstatements as well.[27]

By invoking the *Basic* presumption using the fraud-on-the-market theory, plaintiffs can indirectly prove that the misrepresentations affected the market price.[28] Without the *Basic* presumption, individual plaintiffs would each need to prove individual reliance, "making class certification difficult or impossible."[29] However, the Court in *Basic* acknowledged that defendants may rebut the presumption by showing that the misrepresentations did not lead to the price distortion or that the plaintiff traded, or would have traded, regardless of knowing about the false statement.[30]

D. The Parties' Arguments in *Halliburton II*

Halliburton's initial arguments focused on overruling *Basic* and attacked its underlying premises.[31] Halliburton first contended that markets are not in fact efficient and do not always reflect available information.[32] Halliburton further argued that many investors do not always depend on the price they see and instead try "to 'beat the market' by buying the undervalued stocks and selling the overvalued ones."[33] It shared this contention with other critics of the *Basic*

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[24] *Halliburton*,134 S. Ct. at 2408 (citing *Basic*, 485 U.S. at 248); *Basic*, 485 U.S. at 247 ("Indeed, nearly every court that has considered the proposition has concluded that where materially misleading statements have been disseminated into an impersonal, well-developed market for securities, the reliance of individual plaintiffs on the integrity of the market price may be presumed.").
[25] *Basic*, 485 U.S. at 247.
[26] *Id.* at 241.
[27] *Id.* at 247.
[28] *Halliburton*, 134 S. Ct. at 2415.
[29] Adam Liptak, *New Hurdle in Investors' Class Actions*, N.Y. TIMES, June 24, 2014, at B1.
[30] *Basic*, 485 U.S. at 248.
[31] *See Halliburton*, 134 S. Ct. at 2407, 2409.
[32] *Id.* at 2409.
[33] *Id.* at 2410.

presumption, who also think that "investors buy or sell on the speculation the market has mispriced a particular security."[34] Halliburton further argued that the *Basic* presumption, by presuming that common issues predominate over individual issues, essentially eliminates Federal Rule of Civil Procedure 23(b).[35] Finally, Halliburton argued that the Court should overrule the *Basic* presumption because the presumption allows frivolous lawsuits into court, which in turn runs up litigation costs for businesses.[36]

As alternatives to overruling *Basic*, Halliburton proposed two alterations.[37] First, Halliburton suggested that in order to invoke the *Basic* presumption, the EPJ Fund should have to prove Halliburton's misrepresentation changed the stock price.[38] Second, Halliburton proposed that, at the class certification stage, Halliburton should be able to rebut the *Basic* presumption with direct evidence of no price impact.[39]

E. The *Halliburton II* Majority Opinion

Chief Justice Roberts, who wrote for the majority, first addressed Halliburton's arguments for overruling *Basic*.[40] The Court explained that the *Basic* rationale was not premised on the assumption that markets are *always* efficient, but rather the idea that changes in stock price generally reflect professional investors' considerations of most public, material statements about a company.[41] Moreover, that the Court in *Basic* permitted the defendant to rebut the presumption further showed that the Court did not assume stocks operated in perfectly efficient markets.[42] The Court rejected Halliburton's argument that value investors undermine the *Basic* presumption and held that even those investors that try to "beat the market" still rely on the fact that the "market price will eventually reflect material information."[43] With regard to Federal Rule of Civil Procedure 23, the Court held that the

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[34] *See* Bravin & Kendall, *supra* note 4.
[35] *See Halliburton*, 134 S. Ct. at 2412.
[36] *See id.* at 2413.
[37] *Id.*
[38] *Id.*
[39] *See id.*
[40] *See id.* at 2407.
[41] *Id.* at 2410.
[42] *Id.*
[43] *Id.* at 2411.

Basic decision merely explains what the plaintiffs have to prove to satisfy the predominance requirement without easing the burden of proving predominance.[44]

The Court adhered to *stare decisis* and noted that Congress could pass legislation disposing of the *Basic* presumption if it found the presumption inappropriate.[45] Furthermore, the Court dismissed Halliburton's public policy arguments and suggested that those types of arguments should be directed to Congress.[46] The Court also explained that Congress had already enacted the Private Securities Litigation Reform Act of 1995 ("PSLRA") and the Securities Litigation Uniform Standards Act of 1998 ("SLUSA") in order to address frivolous, meritless, and abusive securities fraud suits.[47]

The Court next considered Halliburton's proposals to alter the *Basic* doctrine, short of overruling the decision.[48] The Court rejected Halliburton's proposal that the EPJ fund should have to prove price impact, because such a rule would take away the "first constituent presumption" of the *Basic* presumption—that any material misrepresentation affects the stock price if the stock trades in an efficient market.[49] Halliburton essentially argued to overrule *Basic* again, and the Court quickly dispatched this argument.[50]

The Court accepted Halliburton's last argument, however, and held that Halliburton could rebut the *Basic* presumption directly at the class certification stage by introducing evidence that the misrepresentations did not affect the stock's market price.[51] The Court

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[44] *Id.* at 2412.
[45] *Id.* at 2411.
[46] *Id.* at 2413 ("Finally, Halliburton and its *amici* contend that, by facilitating securities class actions, the *Basic* presumption produces a number of serious and harmful consequences. Such class actions, they say, allow plaintiffs to extort large settlements from defendants for meritless claims; punish innocent shareholders, who end up having to pay settlements and judgments; impose excessive costs on businesses; and consume a disproportionately large share of judicial resources. . . These concerns are more appropriately addressed to Congress, which has in fact responded, to some extent, to many of the issues raised by Halliburton and its *amici*.") (internal citation omitted).
[47] *Id.*
[48] *See id.* at 2413.
[49] *Id.* at 2414.
[50] *Id.*
[51] *Id.* at 2417.

found no reason to arbitrarily constrain Halliburton to only indirectly rebutting the presumption by showing an inefficient market.[52]

F. Concurring Opinions in *Halliburton II*

In concurrence, Justice Ginsburg observed that the majority's holding "may broaden the scope of discovery available at [the class] certification [stage]," yet should not have a big impact on plaintiffs with potential claims.[53]

In another concurring opinion, Justice Thomas, joined by Justices Scalia and Alito, proposed to overrule *Basic*.[54] Justice Thomas began by criticizing the *Basic* presumption's foundation.[55] He first explained that sometimes markets either plainly do not incorporate information or do so inaccurately, and that even "well-developed" markets function inefficiently.[56] Second, he asserted that investors do not rely on the integrity of the market price but rather seek to benefit from inaccuracies in market prices.[57]

Justice Thomas also argued that *Basic* contradicts the case law concerning Rule 23's class certification requirements which require "evidentiary proof" that common questions of fact and law predominate over individual ones.[58] Justice Thomas also explained that class action procedure hinders the defendant's ability to rebut the *Basic* presumption, because defendants can only target "class representatives" at the class certification stage and only one plaintiff needs to survive the rebuttal for the class action to proceed.[59]

At the end of his opinion, Justice Thomas summarized the problems created by the *Basic* presumption.[60] Once the plaintiffs have successfully invoked the presumption of reliance, the reliance element no longer blocks the plaintiffs' success on the claim "even though many class members will not have transacted in reliance on price

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[52] *Id.* at 2416–17.
[53] *Id.* (Ginsburg, J., concurring).
[54] *Id.* at 2417–18 (Thomas, J., concurring).
[55] *See id.* at 2420–21.
[56] *Id.* ("This view of market efficiency has since lost its luster. . . . [E]ven 'well-developed' markets (like the New York Stock Exchange) do not uniformly incorporate information into market prices with high speed.")
[57] *Id.* at 2422.
[58] *Id.* at 2423 (citing Comcast Corp. v. Behrend, 133 S. Ct. 1426, 1432 (2013)).
[59] *Id.* at 2424.
[60] *See id.* at 2424–25.

integrity."[61] Thus, investors can bring securities fraud claims as a "scheme of investor's insurance," protecting any investor who loses money, regardless of whether the investor's loss is causally related to the defendant's fraudulent activity.[62] Finally, because the presumption of reliance is judge-made law, Justice Thomas noted that the Court needs to correct the issue and overrule the *Basic* presumption, not Congress.[63] A requirement of actual reliance should replace the *Basic* presumption, he concluded.[64]

G. Consequences of the *Halliburton II* Decision

Halliburton II may help to reverse the trend of increasing securities fraud class action claims, and reduce the number of these claims filed in general, by allowing defendants to rebut the presumption of reliance at an earlier stage in the litigation.[65] Some observers have asserted that the holding will make class action suits more difficult to bring and more costly for plaintiffs, because experts will have to testify on price impact at the class certification stage.[66] Furthermore, because most securities fraud class action suits are brought by lawyers pursuant to a contingency fee arrangement, lawyers will likely become more selective of which claims they pursue in light of the potentially higher costs of suit post–*Halliburton II*.[67] With the ability to directly rebut *Basic*'s presumption at the class certification stage, defendants may be less likely settle, which may also cause fewer plaintiffs to pursue their claims.[68]

Despite these predictions, other observers suggested that "[this] ruling . . . should not unduly restrict the rights of investors and the conduct of securities class actions should not substantially change in the wake of this decision."[69] This is largely because "the burden for

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[61] *Id.* at 2424.
[62] *See id.* at 2424–25.
[63] *Id.* at 2426.
[64] *Id.* at 2425.
[65] Pell et al., *supra* note 5, at 3.
[66] *Id.*
[67] *Id.*
[68] *See* Bravin & Kendall, *supra* note 4.
[69] Daniel S. Sommers & Steven J. Toll, *Comments on Supreme Court's Halliburton Securities Class Action Decision*, COHEN, MILSTEIN, SELLERS & TOLL PLLC (June 23, 2014), http://www.cohenmilstein.com/news.php?NewsID=674, *archived at* http://perma.cc/DJR2-59EG.

demonstrating the lack of price impact rests solely on the defendants."[70] David Boies, counsel for the plaintiffs, also suggested that permitting defendants to rebut price impact at the class certification stage "will not significantly limit securities lawsuits."[71]

H. Conclusion

Halliburton II's holding may reduce the number of securities fraud class action lawsuits because litigation costs at the class certification stage might increase.[72] Perhaps most importantly though, after about twenty-five years of jousting, corporations dented the armor of *Basic*'s presumption and can now rebut the *Basic* presumption at the class certification stage.[73] Could the *Halliburton II* decision lead to further weakening of the *Basic* presumption in the future? Furthermore, Justice Thomas's concurrence, which suggested that the Court should overrule *Basic* entirely, garnered three votes, which suggests that a significant portion of the Court would further weaken the *Basic* presumption in the future if given the chance.[74] The *Halliburton II* decision, despite making only minor adjustments to the Court's *Basic* doctrine, may suggest that larger changes in securities fraud class actions are to come in the near future.

Steven Barros[75]

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[70] *Id*.
[71] Bravin & Kendall, *supra* note 4.
[72] Pell, *supra* note 5, at 3.
[73] *See* Bravin & Kendall, *supra* note 4.
[74] *See supra* text accompanying notes 55–65.
[75] Student, Boston University School of Law (J.D. 2016).