Alert

Class and Derivative Actions and
Securities Litigation and Enforcement Client Service Groups

To: Our Clients and Friends

June 23, 2014

Securities Defendants Will Have New Tool To Use In Opposing Class Certification But Fraud-On-The-Market Theory Survives Under Supreme Court Decision

The U.S. Supreme Court today issued its long awaited decision in *Halliburton v. Erica P. John Fund, Inc.*, providing securities fraud defendants with a significant weapon to use in opposing class certification, but declining to overturn the fraud-on-the-market theory that has served as the basis for securities class actions for the past 25 years.

That theory confers on plaintiffs the benefit of a presumption that all purchasers of stock trading in an efficient market relied on any alleged misrepresentation, because public securities markets are presumed to digest and thus reflect all publicly available, material information. Despite the urging of Halliburton and its supporters, the Court left the fraud-on-the-market presumption intact. However, the Court held that defendants could rebut that presumption at the class certification stage, rather than having to wait until summary judgment motions or trial.

While it will take some time to see how lower courts apply the decision, securities fraud defendants at the class certification stage will likely now sharpen their focus on developing expert evidence, such as "event studies," that can be used to rebut claims that alleged misrepresentations affected the price of a company's securities.

The significance of the decision arises from *Basic Inc. v. Levinson*, 485 U.S. 224 (1988). That case eased the burden plaintiffs' lawyers had to meet in order to obtain certification of a class in a securities fraud action under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. Instead of requiring each investor in the class to prove that he or she had relied on the alleged misstatements, *Basic* created a presumption of reliance — reliance not on any particular statement by a company in its financial statements or SEC filings, but rather, reliance on the fact that all available public information was reflected in the company's stock price.

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Halliburton, supported by the U.S. Chamber of Commerce and numerous other business groups appearing as *amici curiae*, had argued for outright abandonment of *Basic*, on the theory that its underlying premise — the "efficient capital markets hypothesis" — was no longer viable. The plaintiff's lawyers, along with the SEC and various consumer advocates who submitted their own *amicus* briefs, argued to preserve *Basic*. They also argued that evidence to rebut price impact should not be heard until after a class certification decision.

After oral argument, many commentators predicted that the Court would come down somewhere between those two poles. Today's decision bore out those predictions. The majority opinion, written by Chief Justice Roberts, invoked *stare decisis*, the principle against overruling precedents absent "special circumstances," and it also rejected what it said were mischaracterizations of *Basic* by the defense side advocates: "Halliburton's criticisms fail to take *Basic* on its own terms." The Court also addressed arguments from Halliburton and its supporters that the *Basic* presumption encourages the filing of meritless claims that impose significant costs on businesses and consume judicial resources, noting that those concerns would be better addressed by Congress.

The majority emphasized that *Basic* only concluded that most, not all, investors, rely on market efficiency, and that *Basic* itself created only a rebuttable presumption of reliance.

Overruling *Basic* was defendants' home-run argument. Halliburton also advanced two fall-back positions. Its more ambitious fall back was to require plaintiffs to prove that the defendants' misrepresentations actually affected the stock price, or caused price impact, as a condition of invoking the *Basic* presumption and obtaining class certification. Its alternative was to permit defendants to "rebut the presumption of reliance with evidence of a *lack* of price impact, not only at the merits stage — which all agree defendants may already do — but also before class certification."

It was on this point, permitting defendants to put on evidence of lack of price impact before class certification, that the Court sided with the defense advocates.

As the Court noted, both plaintiffs and defendants in securities class actions use "event studies," which are regression analyses concerning how the market price of issuers' stock responds to various publicly reported events. Plaintiffs, the Court noted, use these studies to demonstrate how the market for a company's stock considers material public information. While plaintiffs' lawyers did not dispute that defendants could use event studies on a class certification motion to address general market efficiency, they argued that evidence of price impact should not be considered for the purpose of rebutting the fraud-on-the market presumption altogether and thus finding a lack of common reliance.

In its key holding, the Court rejected this argument, and held that defendants may use event studies to refute price impact and defeat a class certification motion.

Considering how vigorously the case was contested and the large number of business and investors' advocates who weighed in, it was striking that the Court issued an opinion with no dissents. But that hardly signaled unanimity.

Justice Thomas, joined by Justices Scalia and Alito, issued a concurrence that made clear those three thought the Court should have gone further and overruled the fraud-on-the-market theory adopted in

Basic. Justice Ginsburg, joined by Justices Breyer and Sotomayor, issued a one-paragraph concurrence saying they joined the majority on the basis that defendants still bore a key burden in opposing class certification. Justices Kennedy and Kagan simply joined in the Chief Justice's majority opinion.

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