Halliburton: SCOTUS Reaffirms Fraud-on-the-Market Presumption, Allows Attack at Class Cert Stage

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On Monday the Supreme Court issued its much anticipated decision in Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317, 2014 WL 2807181 (U.S. June 23, 2014), rejecting all pleas to overturn the fraud-on-the-market presumption of reliance established in Basic Inc. v. Levinson, 485 U.S. 224 (1988). Writing for five other Justices (Kennedy, Ginsburg, Breyer, Sotomayor and Kagan), Chief Justice Roberts announced the Court will “adhere” to its prior ruling in Basic that plaintiffs are not required to show actual reliance to establish a Rule 10b-5 fraud claim. Instead, they may satisfy the reliance element “by invoking a presumption that a public, material misrepresentation will distort the price of stock traded in an efficient market, and that anyone who purchases the stock at the market price may be considered to have done so in reliance on the misrepresentation.”

Defendants, however, were not left without some relief under Monday’s ruling. The Court also ruled that defendants may rebut the presumption at the class certification stage by showing lack of “price impact,” i.e., “evidence that an alleged misrepresentation did not actually affect the market price of the stock.”

The Halliburton Case

In the underlying lawsuit, filed by a class of Halliburton investors in 2002, the Texas district court initially denied the plaintiffs’ class certification motion for failure to show loss causation (a causal connection between any alleged misrepresentations and plaintiffs’ losses), and the Fifth Circuit affirmed. The Supreme Court later reversed, holding that securities fraud plaintiffs do not need to prove loss causation at the class certification stage.

On remand, Halliburton argued that the same evidence disproving loss causation also negated price impact, thereby rebutting the fraud-on-the-market presumption. The district court disagreed and certified the class. The Fifth Circuit again affirmed, holding that Halliburton could rebut the fraud-on-the-market presumption with price impact evidence only at trial, not at the class certification stage.

No Economic or Other “Special Justification” for Overturning Basic

Halliburton argued on appeal that the Basic presumption both “contravenes congressional intent” in passing the 1934 Exchange Act, and “has been undermined by subsequent developments in economic theory.” Although the Court’s judgment was unanimous, Justice Thomas (joined by Justices Scalia and Alito) also wrote a separate concurrence arguing that Basic should be overruled because today’s economic realities have “undermined the foundations of the Basic presumption.”

The Court found, however, that Basic had considered and rejected the same legislative intent arguments more than 25 years ago. Further, none of the economic “debates” cited by critics “so discredits Basic” or establishes the “special justification” required to overturn long-settled precedent. Dickerson v. United States, 530 U.S. 428, 443 (2000).

For example, evidence that markets are not always efficient in reflecting public information is no reason to abandon the “efficient capital markets hypothesis.” Even the harshest critics “acknowledge that public information generally affects stock prices.” The presumption therefore “does not rest on a ‘binary’ view of market efficiency,” and “in making the presumption rebuttable, Basic recognized that market efficiency is a matter of degree and accordingly made it a matter of proof.”

Similarly, the presence of value investors who view price integrity as only “marginal or irrelevant” does not destroy the premise that investors invest “in reliance on the integrity of [the market] price.” They too must “implicitly rely[y]” on the fact that a stock’s market price will eventually reflect material information—how else could the market correction on which [their] profit depends occur?

The Court also rejected suggestions that Basic is inconsistent with recent decisions in Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994), and Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008), both of which declined to eliminate (or diminish) the reliance element by extending Rule 10b-5 liability to new categories of defendants who had not made any misrepresentations (e.g., aiders and abettors). The Basic presumption, in contrast, merely permits another means of satisfying the reliance element.

Defendants Can Rebut Fraud-on-the-Market at the Class Certification Stage
Lastly, the Court determined that prohibiting defendants from rebutting fraud-on-the-market presumptions before class certification “makes no sense.” Defendants already “may introduce price impact evidence at the class certification stage” to counter evidence of market efficiency. And plaintiffs themselves often try to prove such efficiency with price impact evidence in the form of “event studies” or other regression analyses. There is no reason defendants should not be able to rely on the same evidence to rebut the Basic presumption altogether at the class certification stage.

Nothing in the Court’s recent class certification ruling in Amgen Inc. v. Connecticut Retirement Plans and Trust Funds requires a different result. There, the Court held that the issue of materiality should be left to the merits stage, because it does not bear on the predominance requirement of Rule 23(b)(3), even though materiality is also a prerequisite for showing the Basic presumption. Evidence of price impact, in contrast, is “Basic’s fundamental premise,” and therefore “has everything to do” with the issue of predominance at the class certification stage. To “maintain the consistency of the presumption with the class certification requirements” of Rule 23, defendants must be allowed a chance “before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price.”

Monday’s decision in Halliburton was certain to bring sighs of relief from investors and plaintiff securities lawyers, many of whom feared that a ruling forbidding fraud-on-the-market presumptions would deal a death blow to securities class action litigation. While the high court’s decision exposes the Basic presumption to earlier attack, which will give both the courts and defendants more tools to eliminate meritless cases, it stopped short of eliminating the rule altogether.

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