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U.S. SUPREME COURT ENFORCES PRICE IMPACT REQUIREMENT FOR SECURITIES FRAUD CLASS ACTIONS

To Our Clients and Friends:

On June 23, 2014, the Supreme Court issued its much-anticipated decision in *Halliburton Co. v. Erica P. John Fund, Inc.*, 573 U.S. ___ (2014) (*Halliburton II*). Securities plaintiffs and their lawyers can breathe easier because the presumption of reliance--the legal doctrine announced in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), without which most securities cases could not proceed as class actions--has survived. By a 6-3 vote, the Court determined that Halliburton had not shown "special justification" for overruling *Basic*. But securities defendants also achieved a significant victory: The Court ruled that the presumption of reliance may be defeated at the class certification stage by evidence that each challenged misrepresentation did not affect the market price of the security at issue. This "price impact" ruling will have significant ramifications in future cases, as it provides defendants with significant new arguments to defeat Rule 10b-5 class claims.

I. ***Basic* Lives**

The lead issue in *Halliburton II* was whether the Court should overrule *Basic*. A Rule 10b-5 cause of action requires proof that a plaintiff relied on the alleged misrepresentation or omission in purchasing or selling the security. In *Basic*, the Court held that a plaintiff can invoke a rebuttable presumption of reliance using the fraud-on-the-market theory, which posits that the market price of a security traded in a well-developed market reflects all publicly available information, including misrepresentations. To qualify for the presumption of reliance, the plaintiff must show that: the alleged misrepresentation was publicly known; it was material; the security traded in a well-developed, or efficient, market; and the plaintiff traded the security between the time of the misrepresentation and the time the truth was revealed. Slip. op. 6-7 (citing *Basic*, 485 U.S. at 248 n.27). A defendant may rebut the presumption in any number of ways--including by showing "that the alleged misrepresentation did not, for whatever reason, actually affect the market price." *Id.* at 7.

In *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179, 2183 (2011) (*Halliburton I*), an earlier decision in this litigation, the Court held that securities plaintiffs need not prove, at the class certification stage, that the alleged misstatement caused investor losses; the Court vacated the court of appeals' contrary holding and invited the lower court on remand to consider other arguments against class certification. Slip op. 3. And in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 133 S. Ct. 1184, 1195-96 (2013), the Court held that the materiality of the alleged misstatement--that is, whether a reasonable investor would have considered the misstatement to have significantly altered the total mix of available information--need not be established at the class certification stage. Slip op. 21. In separate opinions, four Justices expressed interest in reconsidering *Basic* in light of new

scholarship calling into question its presumption of reliance. *Amgen*, 133 S. Ct. 1184, 1204 (2013) (Alito, J., concurring); *id.* at 1208 n.4 (Thomas, J., dissenting).

Halliburton II builds on the previous decisions in *Halliburton I* and *Amgen*. The majority, in an opinion authored by Chief Justice Roberts, rejected Halliburton's argument that the *Basic* Court's conception of robust market efficiency is inconsistent with recent empirical scholarship showing more varied and less efficient markets. Slip op. 9. The majority noted that *Basic* itself declined to adopt any particular theory of market efficiency but rather "recognized that market efficiency is a matter of degree" and thus "a matter of proof." *Id.* at 10. The majority also rejected Halliburton's suggestion that certain classes of investors--such as "value investors" who trade on the belief that market price does *not* reflect the stock's intrinsic value--undermine the premise of the *Basic* presumption of reliance. For the majority, it was enough that "*most* investors" can be presumed to rely on a stock's price as indicative of its value. *Id.* at 11-12.

The majority also disagreed with Halliburton's characterization of the *Basic* presumption as inconsistent with the Court's more recent decisions narrowly construing the Section 10b-5 cause of action. *Basic*'s presumption, the majority noted, does not alter the elements of the Rule 10b-5 cause of action, but merely provides an alternative means for satisfying the element of reliance. Slip op. 13-14. The majority similarly rejected Halliburton's argument that the presumption is inconsistent with the Court's recent decisions on class certification, including *Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011), and *Comcast Corp. v. Behrend*, 133 S. Ct. 1426 (2013), which established that a plaintiff must prove, not merely plead, the Rule 23(b) class certification requirements. For securities plaintiffs to avail themselves of the presumption before class certification, the majority explained, they still must carry their "burden of proving" the presumption's prerequisites (with the exception of materiality). Slip op. 14.

Justice Thomas, joined by Justices Scalia and Alito, wrote a separate opinion sharply disagreeing with the Court's decision to leave the *Basic* presumption in force. Drawing heavily on logic and "economic realities" (slip op. 2 (Thomas, J., concurring in judgment)), these Justices would have overruled *Basic*'s presumption as being wrongly decided, inconsistent with the Court's recent class certification jurisprudence, and effectively irrebutable in practice. *Id.* at 5. According to Justice Thomas, many of the assumptions underlying the *Basic* presumption--such as the hypotheses that well-developed markets are efficient and investors buy stock on the belief that its price accurately reflects its value--are often false. *Id.* at 9-11. Moreover, Justice Thomas argued, *Basic*'s presumption allows securities plaintiffs to bypass the need to establish class certification requirements with "evidentiary proof." *Id.* at 11. Accordingly, Justices Thomas, Scalia, and Alito would have declined to give *stare decisis* effect to *Basic*. *Id.* at 15-18.

II. Price Impact

The second issue in *Halliburton II* was whether and how evidence of "price impact" can be considered at the class certification stage. Price impact is a measure of "'whether the alleged misrepresentations affected the market price in the first place.'" Slip op. 17 (majority) (quoting *Halliburton I*, 131 S. Ct. at

2187). Halliburton argued that price impact must be established as a prerequisite to class certification in securities cases.

The Court first rejected the argument that the plaintiff should have to prove price impact to show entitlement to the presumption. Slip op. 16-18. The majority acknowledged that three of the four prerequisites for *Basic*'s presumption--publicity, materiality, and market efficiency--"are directed at price impact," and that the presumption collapses without price impact. *Id.* at 17 (citing *Amgen*, 133 S. Ct. at 1199). The majority reasoned that while plaintiffs are required to provide such indirect evidence of price impact, requiring them to go further and provide direct proof of price impact at the certification stage would be tantamount to eliminating *Basic*'s presumption altogether, because it would eliminate the "constituent presumption" that a misrepresentation affects stock price where the misrepresentation is public and material and where the stock is traded in an efficient market. *Id.* at 17-18.

The Court agreed with Halliburton, however, that securities defendants are "allowed to defeat the [*Basic*] presumption at the class certification stage through evidence that the misrepresentation did not in fact affect the stock price." Slip op. 18. Given that plaintiffs often introduce evidence of the existence of price impact in the form of statistical "event studies," defendants may submit similar price impact evidence, including as to each alleged misstatement, prior to class certification. *Id.* at 19. The Court rejected the plaintiffs' effort to preclude defendants from attempting to rebut *Basic*'s presumption before class certification, citing the "bizarre results" that such a rule would achieve, as shown in the following hypothetical:

> Suppose a defendant at the certification stage submits an event study looking at the impact on the price of its stock from six discrete events, in an effort to refute the plaintiffs' claim of general market efficiency. All agree the defendant may do this. Suppose one of the six events is the specific misrepresentation asserted by the plaintiffs. All agree that this too is perfectly acceptable. Now suppose the district court determines that, despite the defendant's study, the plaintiff has carried its burden to prove market efficiency, but that the evidence shows no price impact with respect to the specific misrepresentation challenged in the suit. The evidence at the certification stage thus shows an efficient market, on which the alleged misrepresentation had no price impact. And yet under [plaintiffs'] view, the plaintiffs' action should be certified and proceed as a class action (with all that entails), even though the fraud-on-the-market theory does not apply and common reliance thus cannot be presumed.

Id. at 19-20. "Price impact is thus an essential precondition for any Rule 10b-5 class action," the Court concluded. *Id.* at 21.

The Court disagreed with the lower court's reliance on *Amgen* to conclude that Halliburton could not introduce evidence of lack of price impact to defeat class certification. Whereas *Amgen* held that materiality need not be proven at the class certification stage, price impact is "'*Basic*'s fundamental premise'" and "has everything to do with the issue of predominance at the class certification stage." Slip op. 22. The price impact inquiry at the class certification stage need not be limited to

indirect evidence of publicity and market efficiency, but can be established--or disproved--through direct evidence as well. *Id.*

III. Road Ahead

With respect to *Basic*'s presumption of reliance, *Halliburton II* essentially confirms the status quo--securities plaintiffs may continue to invoke the presumption if they can establish its predicates.

The real import of *Halliburton II* lies in its articulation of the price impact standard. The Court endorsed the view that price impact must be evaluated on a misrepresentation-by-misrepresentation basis. As the Court explained, the *Basic* presumption "does not require courts to ignore a defendant's direct . . . evidence showing that the alleged misrepresentation did not actually affect the stock's market price." Slip op. 21. The defendant may introduce event studies or other direct evidence regarding the effect on market prices of each "discrete event[]," as the Court termed them. *Id.* at 19. If price impact is lacking as to that event then the presumption lacks an essential predicate and the plaintiffs must prove actual reliance. This is a significant shift from the way many plaintiffs currently invoke the presumption at the certification stage: They often present an expert report attesting to the overall efficiency of the market during the proposed class period, and little else. *Halliburton II* now makes clear that even if (or, perhaps, especially if) the market was efficient, then the absence of price impact for any or all of the challenged misrepresentations will disentitle the plaintiff to the presumption of reliance and therefore common proof of reliance. This is a very important new tool for securities defendants to use.

By specifically endorsing event studies, moreover, the Court has recognized that district courts will have to resolve the "battle of the experts" at the certification stage. This necessarily follows from the Court's recent Rule 23 cases--including *Dukes* and *Comcast*--which hold that a plaintiff must prove the prerequisites to certification and that the district court must make findings. As the Supreme Court has explained, "the 'class determination generally involves considerations that are enmeshed in the factual and legal issues comprising the plaintiff's cause of action.'" *Comcast*, 133 S. Ct. at 1432 (quoting *Dukes*, 131 S. Ct. at 2551). *Halliburton II* makes clear that the same principle extends to securities class actions. Thus, while defendants may have the initial burden of producing price impact evidence, the ultimate burden of persuasion rests with plaintiffs as the proponents of class certification.

Justice Ginsburg's brief concurrence tries to minimize the significance of the Court's opinion, arguing that that decision "should impose no heavy toll on securities-fraud plaintiffs with tenable claims." Slip op. 1 (Ginsburg, J., concurring). But future cases will show whether that prediction is wishful thinking or whether *Halliburton II* ushers in a new era for defendants seeking to rebut *Basic*'s presumption of reliance and defeat class certification in securities actions.

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Gibson Dunn filed a brief for Vivendi S.A. as *amicus curiae* in support of Halliburton, arguing that the Supreme Court should abrogate the *Basic* presumption of reliance.

Gibson, Dunn & Crutcher's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Appellate and Constitutional Law or Securities Litigation practice groups, or the authors of this alert:

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