The U.S. Supreme Court Hears *Halliburton II*

By Miranda Schiller

March 10, 2014

The Supreme Court heard argument in *Halliburton II* last week.[1] At issue is whether the Court should overrule the fraud on the market presumption that it adopted in its 1988 decision, *Basic Inc. v. Levinson*,[2] which obviated the need for plaintiffs in securities fraud class actions to plead or prove that they actually relied on a defendant's alleged false statements. Under *Basic*, class plaintiffs may satisfy their initial burden of demonstrating reliance on a false statement simply by showing that the market for a corporate defendant's securities was efficient (such that market prices would reflect the false information), something which is rarely contested in cases involving securities that are actively traded on the New York Stock Exchange. Evidence of whether a company's stock price was artificially inflated by the alleged misrepresentation is relevant to three distinct legal issues that plaintiffs must prove in securities fraud actions: reliance, causation and materiality.

In *Halliburton I*, the Court held that plaintiffs need not demonstrate loss causation at the class certification stage because this in an issue that goes to the merits of their claim.[3] On remand, the Fifth Circuit, acknowledging its error in requiring such evidence at class certification, concluded that *Halliburton I* conversely prohibited the defendant from using an event study[4] to rebut reliance – *i.e.,* to show that the alleged corrective disclosures had no statistically significant impact on its stock price and therefore there was no artificial price inflation.

Halliburton seeks to have *Basic*'s efficient market hypothesis overruled as an invalid economic theory – and in particular, as one that effectively forecloses defendants from rebutting reliance at the class certification stage. However, little of the Court's questioning focused on this issue. Instead, the argument centered on an alternative approach to refining *Basic* which was advanced by both Halliburton itself and an amicus curiae group of law school professors: [5] permitting defendants to rebut reliance at the class certification phase by using event studies to show that the statements at issue had no impact on stock price. Showing that a stock's price was not artificially inflated is one way to rebut *Basic's* reliance presumption. The law professors' brief was described by Justice Kennedy as a "midway position." The Justices probed both sides, as well as the Deputy Solicitor General, representing the SEC, about the practical consequences to investors and securities markets of allowing the fraud on the market presumption to be rebutted at class certification through the use of event studies that test whether the price of a security was impacted by the alleged misrepresentation.

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[1] *Halliburton Co. and David Lesar v. Erica P. John Fund*, No. 13-317 (U.S. filed Sept. 9, 2013).

[2] *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

[3] *Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (U.S. 2011).

[4] An event study is a regression analysis that measures the effect of an event, such as a company's earnings announcement, on that company's stock price.

[5] Brief of Law Professors As Amici Curiae In Support of Petitioners, No. 13-317 (U.S. Jan. 6, 2014)

The Court's questions in this regard appeared more focused on the practical consequences of the middle ground approach, such as whether it would add significant expense or a degree of difficulty to the class certification process. The Deputy Solicitor General, appearing on behalf of the SEC, was asked whether adopting the law professors' middle ground approach would have any negative impact on securities markets or investors. He responded that it would not. Plaintiff's counsel opened with the argument that Congress endorsed *Basic*'s fraud on the market presumption when it chose not to eliminate it in the 1995 Private Securities Litigation Reform Act (the PSLRA) and suggested that overturning *Basic* would conflict with the PSLRA. But when asked about whether the middle ground approach would create a conflict with the PSLRA, he conceded it would not.

If the Court were to adopt the middle ground approach, what effect would it likely have on securities class action litigation?

Event studies are routinely used at class certification by plaintiffs to demonstrate that the market for an issuer's stock was efficient during the class period, but plaintiffs' event studies at class certification often omit any price impact analyses showing whether the alleged misstatements at issue in the litigation actually inflated the issuer's stock price. If the Court adopts the middle ground approach, event studies could be used at class certification by defendants to demonstrate the absence of a statistically significant stock price movement upon revelation of the supposed corrective information, thereby rebutting a claim that the stock price on which plaintiffs relied was artificially inflated. The Court inquired whether allowing this sort of evidence to rebut the presumption of reliance would necessitate merits discovery and whether courts may properly resolve issues that go to the merits of a claim at class certification, as opposed to awaiting summary judgment. The Court was also interested in the number of cases that ever get to the summary judgment phase after being certified as class actions. Only seven percent of securities fraud class actions that are certified as class actions proceed through summary judgment because of the *in terrorem* effect of certifying a class.

From the defense perspective, the middle ground approach would allow the early termination of cases in which there is strong economic evidence showing the absence of artificial stock price inflation – *i.e.*, that there was no statistically significant stock price decline following a disclosure that corrects the alleged misstatement. The middle ground approach ought to eliminate, as well as discourage the filing of, cases based on a "leakage" theory: those in which the plaintiff posits that the true facts supposedly "leaked out" to the market over the class period without a single corrective disclosure that resulted in a statistically significant price movement. Even in cases where there are statistically significant stock price movements, defendants would be able to present evidence showing that the price movements were caused by other confounding events, thereby defeating artificial price inflation claims. However, the cost of settlement could go up for those defendants who seek to – but do not succeed in demonstrating the absence of price impact at class certification. Defendants will therefore have to carefully weigh the use of price impact evidence at class certification where it rebuts some but not all artificial price inflation allegations. Defendants who fail to prevail on this issue will likely be left defending primarily on whether they lacked the requisite mental state for fraud-based scienter and/or conducted adequate diligence before making the challenged statement.

There are benefits to the plaintiffs of the middle ground, too: cases where the economic evidence is supportive of price inflation may settle earlier and at higher amounts, with less time and work for their counsel. Even fewer cases may proceed through discovery and summary judgment if the middle ground approach is adopted.

If the Court does adopt the middle ground, there is the prospect that the same evidence as to loss causation which the Fifth Circuit weighed in its 2010 *Halliburton* decision and which resulted in a denial of class certification[6], but which the Fifth Circuit believed it was constrained from weighing on the question of reliance after the second remand, will lead to the same result four years and two Supreme Court decisions later.

A decision is expected by June 2014. To read a transcript of the argument, please follow this link.

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6 *The Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330 (5th Cir. 2010), *vacated, sub nom, Erica P. John Fund, Inc. v. Halliburton Co.*, 131 S. Ct. 2179 (U.S. 2011).