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Basic-ally the Same? The Impact of *Halliburton II* on Securities Fraud Class Actions

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In its eagerly anticipated opinion in *Halliburton Co. v. Erica P. John Fund, Inc.* ("*Halliburton II*"), the U.S. Supreme Court rejected Halliburton's invitation to severely limit securities fraud class actions by overruling the "fraud on the market" presumption of reliance established by *Basic Inc. v. Levinson*, but the Court agreed with Halliburton that defendants should be allowed to defeat class certification by showing a lack of "price impact" at the class certification stage of the litigation.[3] So what would be the appropriate headline for a story announcing the decision in *Halliburton II*? "Supreme Court Keeps Securities Fraud Class Actions Alive" or "Supreme Court Gives Corporations A New Way to Defeat Securities Fraud Class Actions"? Both descriptions are accurate, so the difference depends on one's perspective and expectations. Securities fraud litigators, fearing the possible elimination of their practice area, must have breathed collective sighs of relief. Conversely, for public companies hoping the Court would end securities fraud class actions, the outcome of *Halliburton II* was a disappointment, but the case does give corporations facing such lawsuits a clear weapon in their arsenals.

I. <u>The *Basic* Presumption of Reliance in Securities Fraud Class Actions</u>

So what is the *Basic* presumption and why is the presumption essential to securities fraud class actions? The answer has to do with the "reliance" element of a typical federal securities fraud claim and the "predominance" requirement of Rule 23 of the Federal Rules of Civil Procedure. The Supreme Court has long recognized an implied private cause of action under Section 10(b) of the Securities Exchange Act of 1934, as implemented by the SEC's Rule 10b-5 (a "10b-5 claim").[4] One of the elements of a 10b-5 claim is that the plaintiff relied on the defendant's misrepresentation or omission in deciding to buy or sell securities. This can be simple enough for individual plaintiffs to prove, but the reliance element becomes problematic in a class action. Rule 23(b)(3) allows class actions where "common questions" of law or fact "predominate" over individual questions. If every member of a proposed class had to prove direct reliance on a misrepresentation, this "predominance" requirement would not be met, and the case could not proceed as a class action.[5] Thus, the reliance element of a 10b-5 claim would make a 10b-5 class action virtually impossible.

Enter the *Basic* presumption of reliance. *Basic* held that securities fraud plaintiffs could invoke a rebuttable presumption of reliance, rather than proving "direct" reliance on a misrepresentation. The presumption was based on the "fraud-on-the-market" theory,

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[3] *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S.Ct. 2398, 2417 (2014); *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).
[4] *Halliburton II*, 134 S.Ct. at 2407; 15 U.S.C. § 78j(b); 17 C.F.R. § 240.10b-5.
[5] *Id*. at 2408.

which says that "the market price of share traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." In a sense, it is a two-part presumption: first, the market as a whole is presumed to have "relied" on the misrepresentation, and second, the individual investor is presumed to relied on the integrity of the market. To invoke the presumption, a plaintiff must show that (1) the misrepresentation was public, (2) the misrepresentation was material, (3) the stock traded in an "efficient" market, and (4) the plaintiff traded the stock between the time of the misrepresentation and when the truth was revealed.[6] By making this showing, a plaintiff can invoke the presumption as a ground for class certification without offering evidence of direct reliance by individual investors.

However, from the start the *Basic* presumption was supposed to be rebuttable, not conclusive. *Basic* stated that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance." If the defendant rebuts the presumption, the plaintiff then has to prove direct reliance on the defendant's misrepresentation. But the question *Basic* left unanswered was *when* the defendant could rebut the presumption. Over 25 years later, the Supreme Court has now clarified that issue.

II. A Short History of Securities Fraud Class Actions from *Basic* to *Halliburton II*

Depending on one's point of view, the *Basic* presumption either established an essential tool for investors to vindicate their rights and protect the integrity of U.S. securities markets, or it opened the floodgates to a wave of abusive class actions that force U.S. companies to pay extortionate settlements any time there is a significant dip in their stock prices. But one thing is clear. The *Basic* presumption created a whole new area of litigation and made securities fraud class actions a fact of life for large U.S. companies.

So what happened in the years between *Basic* and *Halliburton II* that led to Halliburton urging the Supreme Court to overrule *Basic*? Here is a short chronology that will help to place the *Halliburton II* case in context:

1988 The Supreme Court established the fraud-on-the-market presumption for securities fraud class actions in *Basic Inc. v. Levinson*.

1995 Congress enacted the Private Securities Litigation Reform Act ("PSLRA") to curb perceived abuses of private securities fraud litigation. The PSLRA included heightened pleading requirements, a safe harbor for forward-looking statements, a stay of discovery pending resolution of a motion to dismiss, and a requirement of proving that the misrepresentation caused the plaintiff's loss, i.e. "loss causation."

[6] *See Halliburton II*, 134 S.Ct. at 2408 (discussing *Basic*).

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