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Legal Insight

Securities Fraud Class Actions Face Supreme Court Test

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On October 17, 2013, U.S. District Judge Ronald A. Guzman of the Northern District of Illinois entered a judgment in favor of 10,902 class members with claims against HSBC Holdings' subsidiary, Household International, Inc., in the total amount of $2,462,899,616.21. *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, No. 02-C-5893 (N.D. Ill. Oct. 17, 2013), ECF No. 1898. In this securities fraud class action, the plaintiff investors alleged that lender Household International and its officers made false and misleading statements that artificially inflated the company's share price.

Just a few weeks earlier, on October 1, 2013, the U.S. District Court for the District of New Jersey approved a $215 million settlement in a class action securities fraud case against Merck and Co. and Schering-Plough Corp., bringing the total of combined settlements in the consolidated securities fraud cases against Merck and Schering-Plough to $688 million. *In re Schering-Plough Corp. Enhance Secs. Litig.*, 2013 U.S. Dist. LEXIS 141475 (D.N.J. Oct. 1, 2013), ECF No. 49. The Merck/Schering-Plough litigation arose from allegations that the worldwide pharmaceutical companies had concealed material information and made misleading representations relating to their Vytorin and Zetia cholesterol drugs. The plaintiffs alleged that the companies withheld results of a clinical trial that had disproved the companies' public statements about the performance of the drugs.

The class certification of these two cases, as well as the staggering damages judgment amounts in class action securities fraud lawsuits over the past 25 years, was made possible by the U.S. Supreme Court decision in *Basic, Inc. v. Levinson*, 485 U.S. 224 (1988),which opened an avenue by which plaintiffs could obtain class certification to sue companies in mass. However, on November 15, 2013, the Supreme Court granted certiorari in *Halliburton Company v. Erica P. John Fund, Inc.*, No. 13-317 (referred to as "*Halliburton II*" because this is the second appearance of this case in the Supreme Court), which could fundamentally change the current plaintiff-favorable approach, and possibly preclude the ability to bring security fraud class actions altogether.

At issue in this case is the most powerful engine of civil liability ever established in American law: the fraud-on-the-market presumption of reliance under Section 10(b) of the Securities Exchange Act of 1934. That presumption serves as the foundation of a massive, multibillion-dollar litigation industry, and its impact, along with the controversy it has created, has been remarkable.

Brief for Former SEC Commissioners and Officials and Law Professors as Amici Curiae Supporting Petitioners at 3, *Halliburton II*, No. 13-317 (filed Oct. 11, 2013).

The Presumption Adopted in *Basic v. Levinson*

In *Basic,* the Supreme Court issued a landmark ruling that has allowed plaintiffs to band together against corporations in securities fraud class actions without showing that individual investors made investment decisions based on the defendants' fraudulent misrepresentations. *Basic, 485* U.S. at 247. The *Basic* Court created the "fraud-on-the-market" presumption, permitting large numbers of investors to obtain class certification, and lucrative settlements, without any individual showing that an investor relied on the alleged misrepresentations of the company when investing in that company. The Supreme Court established a rebuttable presumption of class-wide reliance on the purported misrepresentations based on the fraud-on-the-market theory as follows:

An investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price. Because most publicly available information is reflected in the market price, an investor's reliance on any public material misrepresentations, therefore, may be presumed for purposes of a Rule 10b-5 action.

Id. at 244–47.

"Misleading statements will therefore defraud purchasers of stock even if the purchasers do not directly rely on the misstatements. The causal connection between the defendants' fraud and the plaintiffs' purchase of stock in such a case is no less significant than in a case of direct reliance on misrepresentations." *Id. at 241–42*. As such, the evidentiary standard to show common reliance to certify a class requires merely a showing that the security was traded on an efficient market—a standard often easily satisfied by the company's stock being traded on a stock exchange.

The district court in *Merck* also rejected the defendants' arguments that the plaintiffs had purchased the stock in question through "mechanical index purchasing and basket trades" and, therefore, could not have relied on the defendants' alleged misstatements.

The Court disagrees with the fundamental premise of this contention, however, and finds that the law fully supports the notion that index purchases and the like are in fact a perfect example of reliance on the market. As the Central District of California noted, "Because index purchases seek only to match the index and exclude other considerations, index purchases rely exclusively upon the market to impound representations (including misrepresentations) into securities prices."

In re Schering-Plough Corp. Enhance Secs. Litig., 2012 U.S. Dist. LEXIS 138078, ECF No. 314, at 19 (D.N.J. Sept. 25, 2012).

The current standard does not require evidence that the price was actually affected by a misrepresentation—that is presumed because of the accepted efficiency of the market in incorporating information.

In the HSBC case, not only did the theory support certification of a massive class of investors, but it also provided an example of how *Basic's* fraud-on-the-market analysis could impact the scope of discovery. Following class certification, the defendants served 14 subpoenas on plaintiffs' representatives and advisors. The defendants claimed that the discovery was necessary to disprove the necessary element of reliance. "Reliance is an element of a Rule10b-5 cause of action. Reliance provides the requisite causal connection between a defendant's misrepresentation and the plaintiffs' injury." However, the court granted the plaintiffs' motion to quash the subpoenas, holding that "plaintiffs are pursuing a fraud-on-the-market theory under which they can satisfy the reliance element of securities fraud without proving direct reliance on false representations. The fraud-on-the-market theory allows plaintiffs to establish a class-wide rebuttal presumption of reliance on Household's alleged misrepresentations." *Lawrence E. Jaffe Pension Plan v. Household Int'l, Inc.*, No. 02-C-5893, 2005 U.S. Dist. LEXIS 8610, at *7 (N.D. Ill. Apr. 18, 2005). Without such a presumption, plaintiffs would need to show "proof of individualized reliance from each member of the proposed plaintiff class[,] effectively . . . prevent[ing plaintiffs] from proceeding with a class action, since individual issues then would have overwhelmed the common ones." *Basic*, 485 U.S. at 242.

The bounty for class action plaintiffs, as well as lawyers and experts on both sides of these cases, created by the legal fiction of fraud-on-the-market reliance, could come to an abrupt halt in 2014. The Supreme Court granted certiorari in *Halliburton II* to revisit the fraud-on-the-market exception to the reliance requirement for certification of class action securities fraud cases. As explained below, recent Supreme Court opinions signal the likelihood that the *Basic* fraud-on-the-market exception could be drastically altered or completely eliminated, thereby requiring proof of individualized reliance from each member of a proposed class and effectively preventing individual investors from banding together to sue large corporations for securities fraud.

Possible Implications of a Supreme Court's Decision in *Halliburton II*

The Supreme Court certified two questions for review in *Halliburton II*. The first asks whether the theory allowing a class-wide presumption of reliance should be overruled or, at least, substantially modified. The second asks whether, if the presumption is not eliminated or modified, a defendant can rebut that presumption at the class-certification stage by showing that the purported misrepresentation did not actually distort the subject security price. While the Court has already stated that the presumption may be rebutted by such a showing, it is not clear whether that rebuttal may occur at the class-certification stage. The possibility of allowing the rebuttal early on is significant, and may be outcome determinative, as the certification of a class is generally the threshold barrier that will often determine whether a company will settle the case or expose itself to crippling class-wide damages. By certifying the class based on *Basic's* fraud-on-the-market theory, the district court sent the *Merck* case down a path that has become very familiar. Within months, the case settled.

It appears that the Court has three options by which to resolve *Halliburton II*. It may (1) maintain the status quo as to the evidentiary showing for class-wide reliance, either by explicitly affirming the current law or by avoiding the issue on procedural grounds; (2) eliminate or substantially modify the threshold showing that plaintiffs must make to demonstrate class-wide reliance; or (3) adopt the approach suggested in the second certified question and allow defendants to rebut the initial presumption for class certification at that stage. If the Supreme Court adopts the first option, the fraud-on-the-market theory, as articulated above, will remain the standard. The second two options create interesting questions and are more thoroughly addressed below.

History of Securities Law Litigation

To fully understand the possible implications of *Halliburton II*, it is important to have a general understanding of how we got here. In 1934, Congress passed the Securities Exchange Act (Exchange Act) which established the Securities and Exchange Commission (SEC) and established the legal basis for regulating secondary trading in financial markets in the United States. Section 10b of the Exchange Act and Rule 10b-5 (codified at 17 C.F.R. § 240.10b-5) created a private right of action for individuals damaged by securities fraud. Rule 10b-5 prohibits any act or omission resulting in fraud or deceit in connection with the purchase or sale of any security. Rule 10b-5 requires intentional fraud or deceit by the defendant. In a civil case, a private party must show that he or she was injured because he or she relied on a fraudulent statement or representation when making an investment decision. To recover in a private action under Section 10(b) and Rule 10b-5(b), a plaintiff must prove (1) a material misrepresentation or omission by the defendant; (2) that the defendant acted with scienter; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) the plaintiff's reliance on the misrepresentation or omission; (5) economic loss; and (6) loss causation, meaning that the defendant's misrepresentation or omission proximately caused the plaintiff's loss. *Dura Pharms., Inc. v. Broud*o, 544 U.S. 336, 341–42 (2005).

In 1995, Congress passed the Private Securities Litigation Reform Act (PSLRA) in an effort to curtail frivolous securities fraud claims. The PSLRA heightened requirements for plaintiffs to plead with more particularity the specific fraudulent statements or representations that indicate the defendant's culpable state of mind. The PSLRA also provided procedural mechanisms for trial courts to control various aspects of securities fraud class actions. While certainly eliminating some frivolous cases at the motion to dismiss stage, the PSLRA has not done as much as expected to reduce securities fraud class actions. "The number of suits filed indicates that the courthouse door has remained wide open for plaintiffs after the PSLRA." Richard Painter, Megan Farrell & Scott Adkins, *Private Securities Litigation Reform Act: A Post Enron Analysis* (2002).

Despite the passage of the PSLRA, securities fraud class actions continued to rise. "Through June 2013, new securities class action filings were annualizing at 222 cases for the full year, representing an uptick from the six-year average of 219 suits." *Gibson Dunn 2013 Mid-Year Securities Litigation Update*. In the last 15 years, private securities fraud class action settlements are estimated to total more than $70 billion. Donald C. Langevoort*, Georgetown Pub. Law & Legal Theory Research Paper* No. 13-058, *Judgment Day for Fraud-on-the-Market?: Reflections on* Amgen *and the Second Coming of* Halliburton 2 (Nov. 16, 2013).

Any change in the class-certification standard for these types of cases will have tremendous implications. However, the competing interests of holding companies accountable to their investors for fraud while not subjecting them to unwarranted class action lawsuits do not lend themselves to easy resolution. The Supreme Court's grant of certiorari in

Halliburton II indicates a desire to revisit the issue.

Halliburton II started with a 2002 complaint filed by the Archdiocese of Milwaukee Supporting Fund, Inc. (now known as the Erica P. John Fund, Inc., or simply Fund) against Halliburton and several of its officers, alleging that Halliburton and its officers committed securities fraud by falsifying the company's financial results and misleading the public about (1) its liability for asbestos claims; (2) its probability of collecting revenue on unapproved claims on fixed-price construction contracts; and (3) the benefits of its merger with Dresser Industries.

If the Court Eliminates or Substantially Modifies the Fraud-on-the-Market Presumption

The first question that the Supreme Court certified asks whether the theory allowing a class-wide presumption of reliance should be overruled or substantially modified. Based on the dissent in a recent opinion by the Supreme Court in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, 133 S. Ct. 1184, 1204 (2013), the Court appears eager to reevaluate the validity of the fraud-on-the-market theory. Although the ruling in Amgen was a favorable result for securities fraud class action plaintiffs, as has often been the case with the Roberts Court, the ultimate result may actually portend the demise of such cases. During oral arguments in *Amgen*, Justice Scalia suggested, "So maybe we should overrule *Basic* because it was certainly based upon a theory that simply collapses once you remove the materiality element." Transcript of Oral Argument at 41–42, *Amgen*, 133 St. Ct. 1184 (2013) (No. 11-1085). Justice Kennedy went on to question the fundamental underpinnings of the presumption based on "24 years of economic scholarship." *Id.* at 43.

Sure enough, when the opinion was issued in February 2013, dissenting Justices Scalia, Kennedy, and Thomas, as well as Justice Alito in his concurrence, all commented on the tenuous nature of the presumption. Regardless of whether you agree with the presumption, it is difficult to argue with the comment in Justice Thomas's dissent, joined by Justice Kennedy, that the fraud-on-the-market theory is a "judicially invented doctrine based on an economic theory adopted to ease the burden on plaintiffs bringing claims under an implied cause of action." *Amgen*, 133 St. Ct. at 1213 (Thomas, J., joined by Scalia and Kennedy, JJ., dissenting).

Seizing on what Halliburton calls the Supreme Court's "invitation," it asserts that "[e]conomists now largely agree that Basic's efficient market hypothesis does not reflect reality." Petition for Writ of Certiorari at 15, *Halliburton II*, No. 13-317 (filed Sept. 9, 2013). And it is true that there are many situations in which an otherwise efficient market would not reflect a particular misstatement or misrepresentation in the price of the security. The fraud-on-the-market theory presumes that, in an efficient market, the price of the security, established by being traded in an open and developed securities market, will reflect all relevant publicly available information. However, citing several scholarly articles, Halliburton presents examples of when misrepresentations would not be reflected in the price of the security. These examples include the inflated prices of stock for technology companies during the technology bubble of 1998–2001, and the extended time that it takes to reflect information that, although public, is "difficult to get hold of, complex, or requires special knowledge to comprehend." *Id.* at 15–16 (internal citations omitted).

In rebuttal, the respondents point out that the fraud-on-the-market theory "continues to enjoy widespread support among economists." Brief in Opposition to Petition for Writ of Certiorari at 37, *Halliburton II*, No. 13-317 (filed Oct. 11, 2013). Just as importantly, respondents argue that the efficiency of the market was only a secondary reason for the presumption; instead, they insist that the Court was primarily relying on congressional policy. "The presumption of reliance in this case is consistent with, and, by facilitating Rule 10b-5 litigation, supports, the congressional policy embodied in the 1934 Act. In drafting that act, Congress expressly relied on the premise that securities are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets." *Id.* (citing *Basic*, 482 U.S. at 245–46, and legislative history of the Exchange Act).

Further, respondents, of course, point to the stare decisis value of *Basic* combined with congressional inaction since *Basic* to change the common-law-created presumption. "While Congress has repeatedly acted to make needed adjustments in federal securities law governing private actions, it has directly considered and rejected the extreme step of eliminating the presumption created by *Basic*." *Id.*

If the Supreme Court chooses to address the fundamental presumption of the fraud-on-the-market theory under the first certified question, there are several ways that it could do so. The Court could eliminate any type of presumption in favor of a putative class, which would likely be the most extreme result. In this scenario, the situation the *Basic* Court attempted to avoid in which "proof of individualized reliance from each member of the proposed plaintiff class [would] effectively . . . prevent [plaintiffs] from proceeding with a class action" would be realized. *Basic*, 485 U.S. at 242. Such a ruling would likely end all class action securities fraud claims. A less drastic approach by the Court could be redefining when the presumption will arise. One such example would be upon a showing of an actual distortion of stock price based on the misstatement or misrepresentation, as opposed to an assumption that there was one if the stock was traded on an efficient market. Halliburton advocates this last approach, "[a]t the least," in its petition. Petition for Writ of Certiorari, *supra*, at 17–18.

If the Court Allows Defendants to Rebut the Presumption of Reliance at Class Certification

The Supreme Court could also change the current state of the law through the second certified question before it—whether, if the fraud-on-the-market presumption survives, defendants may rebut that presumption at the class-certification stage.

The *Basic* Court found that the presumption of reliance embodied in the fraud-on-the-market theory appropriately allocated the burden of proof when, as in securities fraud cases, "direct proof, for one reason or another, is rendered difficult" and, absent the presumption, there would be "an unnecessarily unrealistic evidentiary burden on the [securities fraud] plaintiff." *Basic*, 482 U.S. at 245. Nonetheless, the Court explicitly acknowledged that the presumption is just that—a presumption that a defendant may rebut. A defendant can rebut the presumption by "[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." *Id.* at 248.

A question that the *Basic* Court left open and, arguably, a question that has created a circuit split, is at what procedural stage of the litigation the presumption of reliance may be rebutted. The *Basic* Court did state in a footnote that proof of the sort that would rebut the presumption "is a matter for trial," but it did not expressly prohibit challenging the presumption at an earlier stage. Id. at 249 n.29. Since *Basic*, the Second and Third Circuits have ruled that evidence meant to rebut the presumption of reliance may be presented at the class-certification stage. See *In re DVI, Inc. Sec. Litig.*, 639 F.3d 623, 638 (3d Cir. 2011); *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 484 (2d Cir. 2008). The Fifth and Seventh Circuits have ruled that such evidence can only be presented at the merits stage of a lawsuit because such evidence does "not bear on the critical inquiry of whether common issues predominate under Rule 23(b)(3)." *Erica P. John Fund, Inc. v. Halliburton Co.*, 718 F.3d 423, 427 (5th Cir. 2013); *accord Schleicher v. Wendt*, 618 F.3d 679, 685 (7th Cir. 2010).

However, whether the circuit split still exists is a hotly contested issue between the parties in *Halliburton II*. The Fund argues that the Supreme Court's recent decision in Amgen has resolved such a split in favor of not allowing evidence to rebut the presumption of reliance, whereas Halliburton argues that the *Amgen* ruling is limited solely to a separate element of these types of claims—*materiality*. In *Amgen*, the Court held, in a 6-3 decision, that evidence introduced to attempt to rebut the presumption that a misrepresentation *materially* affected a stock's price (also based on the fraud-on-the-market theory) should not be considered to determine whether common issues predominate and whether a class should be certified. *Amgen*, 133 S. Ct. at 1204. The rationale is that, if a misrepresentation did not materially influence the security price, that lack of impact would be the same throughout the class—"the failure of proof on the element of materiality would end the case for one and for all; no claim would remain in which individual reliance issues could potentially predominate." *Id. at 1196*.

The *Amgen* Court effectively overruled the Second and Third Circuit decisions to the extent that those decisions allowed evidence to rebut the presumption of materiality at the class-certification stage. The specific issue of reliance was not addressed, and the element of reliance raises separate considerations. If the presumption of reliance based on the fraud-on-the-market theory is rebutted by a showing that the misstatement or misrepresentation was not actually reflected in the price of the security, it is still possible for a plaintiff to demonstrate that he or she relied on the misstatement or misrepresentation. Ending the case for one plaintiff would not necessarily end the case for all. However, practically speaking, such a rebuttal may have the same result. It seems unlikely that a plaintiff would be able to demonstrate any harm, despite reliance, if there was no distortion in the price of the security and, therefore, could not satisfy other elements of a securities fraud claim. Whether that would change the Court's commonality analysis as to the *reliance* element remains to be seen.

Additionally, allowing the introduction of such rebuttal evidence at the class-certification stage could be tantamount to an analysis of the merits of the case in the context of determining whether to certify a class. A recent Supreme Court case—*Wal-Mart Stores, Inc. v. Dukes*, 131 S. Ct. 2541 (2011)—emphasized the possible need to do just that. *Dukes* was an employment discrimination case having nothing to do with securities fraud, but it is generally regarded as raising the bar for certification of all class actions. In *Wal-Mart*, a potential class of over 1.5 million female employees brought claims for employment discrimination against the retail giant. Most pertinent to *Halliburton II* and future class action hopefuls of all kinds, the Supreme Court, with longtime class action foe Justice Scalia writing for the majority, held in *Wal-Mart* that the decision whether to certify a class action necessarily requires a thorough examination of the merits of a claim to determine commonality. *Wal-Mart*, 131 S. Ct. at 2551–52. The full implications of the *Wal-Mart* decision are well beyond the scope of this article, but the holding deserves mention here as it could provide support for the justices inclined to overrule Basic and eliminate the fraud-on-the-market presumption.

Of course, the Supreme Court has historically treated securities fraud class action specially. “Even though *Wal-Mart* requires plaintiffs to prove a common injury to enable class certification, the extent of this holding for securities class actions is unclear, particularly in light of the Court’s traditional appreciation for the important role of class actions in providing effective remedies for defrauded investors and in maintaining the integrity of the securities markets. The Court has interpreted substantive elements of securities fraud claims in ways that facilitate class actions.” Michael Kaufman & John Wunderlich,“The Judicial Access Barriers to Remedies for Securities Fraud,” *75 Law & Contemp. Probs. 55*, 61 (2012).

Implications of the *Halliburton II* Decision

Based on the questions before the Supreme Court in *Halliburton II*, it appears that the true issue for resolution could be where the burden of proof will lie at the class-certification stage in a securities fraud class action suit. Under the status quo, a presumption of class certification in the plaintiffs’ favor as to the reliance element is easily met. All the putative class representative must do is show that the security at issue was traded in an efficient market. It remains unclear whether a defendant may rebut that presumption during class certification by showing that the market price did not actually reflect the purported misstatement or misrepresentation.

If the Supreme Court agrees with Halliburton on the first certified question, it could remove any presumption in plaintiffs’ favor and effectively prevent these types of claims. Or the Court could redefine the evidentiary standard by which a plaintiff establishes the presumption—possibly by showing that there was an actual change in the price of the security based on the alleged misstatement or misrepresentation. This would place a much higher burden of proof on a plaintiff to establish class-wide reliance for certification, but it would not necessarily bar these claims. Such an approach would still allow for a presumption of reliance to certify a class but would base that presumption on an actual showing of some distortion in the price of the stock caused by the misstatement or misrepresentation.

If the Supreme Court sides with the Fund on the first certified question but with Halliburton on the second certified question, it appears that the initial burden of proof would remain, as it does now, on the plaintiff—namely, showing that the security was traded on an efficient market—but allow a defendant to rebut that presumption early in the proceedings. Defendants could possibly overcome the presumption by showing that, although a stock was traded on an efficient market, that stock price did not actually reflect any purported misstatements and misrepresentations. This would place the burden on a defendant to show that there was no actual price distortion, but it would still allow a defendant to defeat class certification.

Halliburton II is set for oral argument on March 5, 2014, with a decision expected this summer.

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