Securities Fraud Class Action Certification: *Halliburton Co. v. Erica P. John Fund, Inc.*

Michael V. Seitzinger
Legislative Attorney

August 15, 2014

Congressional Research Service
7-5700
www.crs.gov
R43686

CRS REPORT
Prepared for Members and
Committees of Congress

Summary

On June 23, 2014, the U.S. Supreme Court decided a much-anticipated case in the area of federal securities law: *Halliburton Co. v. Erica P. John Fund, Inc.* The history of the case spans more than a decade, through two complete rounds in federal district court, court of appeals, and the Supreme Court. All of the cases so far have dealt with the issue of class certification for securities fraud plaintiffs. The merits of the case have not yet been considered.

Class certification is important in the area of securities law because the merits of the case cannot be considered until after the class of plaintiffs has been certified. A class of many plaintiffs suing a company for fraud that has allegedly resulted in investment losses may be a formidable plaintiff, and a significant amount of money may be involved. So much money may be involved in these lawsuits that proponents and opponents have been very vocal. Proponents of such suits believe that certification requirements should be kept to a minimum to protect investors and the marketplace. Opponents of minimum certification requirements have argued that class action suits are often frivolous and are brought to pressure companies to settle rather than incur large litigation costs. They also argue that plaintiffs' attorneys, who may receive large legal fees, are the only ones who benefit from class actions.

The Halliburton cases illustrate the importance of class certification. There have been two rounds of decisions in the Federal District Court for the Northern District of Texas, the U.S. Court of Appeals for the Fifth Circuit, and the U.S. Supreme Court.

The Erica P. John Fund accused Halliburton of violating federal securities fraud statutes by making material misstatements with respect to its liabilities, revenues, and cost savings. In the first round of cases, the Federal District Court for the Northern District of Texas declined to certify the class on the basis that the plaintiffs had not proved reliance on material misstatements made by Halliburton. The U.S. Court of Appeals for the Fifth Circuit refused to certify the class on the basis that the class had not shown loss causation at the class certification stage. The Supreme Court reversed, holding that the proving of loss causation at the class certification stage is not required. The Court refused to address any other questions which Halliburton might have, such as the presumption of reliance under the "fraud-on-the-market theory" (a theory recognized in the Supreme Court case *Basic v. Levinson*—that, in an efficient, well-developed securities market, all material information is available to the public and this information is reflected in the stock price, resulting in presumptive reliance by plaintiffs on the material misstatements).

In the second round, the district court certified the class, believing that the class certification requirements of Rule 23 of the Federal Rules of Civil Procedure had been met. The Fifth Circuit affirmed certification and concluded that Halliburton could not introduce evidence that its alleged misrepresentations had no impact on the stock price. The Supreme Court held that price impact evidence could be introduced at the class certification stage to rebut the presumption that the shareholders had relied on the alleged misstatements. However, the Court refused to overrule *Basic v. Levinson*'s presumption of reliance provided by the fraud-on-the-market theory.

Halliburton II is not the end of the *Erica P. John Fund v. Halliburton* saga. It may not even be the end of the class certification challenges. Once the class is finally certified, the courts may then face the merits of the case. It seems that another 10 years could easily pass before final resolution occurs. This report will be updated as needed.

Contents

Introduction ... 1
Class Certification ... 2
    Section 10(b) Private Right of Action ... 2
    Class Action ... 3
Halliburton Cases ... 6
    Federal District Court Decision—I ... 6
    Fifth Circuit Decision—I ... 6
    Supreme Court Decision—I ... 7
    Federal District Court Decision—II ... 8
    Fifth Circuit Decision—II ... 8
    Supreme Court Decision—II ... 10
Conclusion ... 13

Contacts

Author Contact Information ... 14

Introduction

On June 23, 2014, the Supreme Court decided a much-anticipated case in the area of federal securities law. The case, *Halliburton Co. v. Erica P. John Fund, Inc.*,[1] presented to the Court the following two questions, both dealing with the certification of a class of securities fraud plaintiffs:

1. Whether the Court should overrule or substantially modify the holding of Basic, Inc. v. Levinson, 485 U.S. 224 (1988), to the extent that it recognized a presumption of class-wide reliance derived from the fraud-on-the-market theory.
2. Whether, in a case where the plaintiff invoked the presumption of reliance to seek class certification, the defendant might rebut the presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock.

Class certification is important in the securities area, and lawsuits are often brought to challenge the class of plaintiffs attempting to be certified. Class certification is necessary before the case can go forward to be decided on the merits. In addition, the amount of money involved in a class action securities lawsuit may be significant. Individuals with small claims may not be willing to pursue individual lawsuits, but individuals who create a class of plaintiffs may result in a formidable plaintiff. A securities class action lawsuit often presents a stronger case and a case better able than small, individual cases to obtain major attorney representation.

Proponents and opponents of securities class actions have actively argued their points.[2] Proponents believe that certification requirements must be kept to a minimum because investors should be able easily to pursue companies that have committed fraud. They argue that investor protection benefits both individual investors and the securities markets in general by maintaining the integrity of the marketplace. Opponents of minimum certification requirements argue that too often investors bring lawsuits that are frivolous, such as when the share price drops for reasons unrelated to fraud, and that companies may feel pressured to pay out large settlements rather than risk even higher litigation costs. They also argue that the only people who benefit from securities class actions are the attorneys who receive large legal fees.

The *Halliburton* cases illustrate the importance of class certification. The history of the cases leading to the second Supreme Court *Halliburton* decision is lengthy, spanning more than a decade. Thus far, the courts have dealt only with the issue of class certification; they have not yet had the opportunity to address the merits of the plaintiffs' arguments. There have been two rounds of decisions in the Federal District Court for the Northern District of Texas, the U.S. Court of Appeals for the Fifth Circuit, and the U.S. Supreme Court. After its second decision, the Supreme Court remanded the case for further proceedings consistent with its opinion. We cannot be certain whether this is the end of the class certification issue, allowing the courts to proceed to the merits of the case, or whether there will be additional Halliburton cases dealing with class certification.

[1] No. 13-317, ___ U.S. ___ (2014).

[2] *See, e.g.*, Thomas Kayes, *Jury Certification of Federal Securities Fraud Class Actions*, 107 NW. U. L. REV. 1851 (2013).

This report will first discuss requirements for securities fraud class action certification and then go through the rounds of the Halliburton federal decisions, ending with the second Supreme Court decision.

Class Certification

Section 10(b) Private Right of Action

Two major federal securities laws, which form the basis for the regulation of securities in the United States, were enacted in the wake of the stock market crash of 1929. These laws are the Securities Act of 1933,[3] which makes it illegal to offer or sell securities to the public unless they have been registered with the Securities and Exchange Commission (SEC), and the Securities Exchange Act of 1934,[4] which requires ongoing company disclosures to the investing public through annual, quarterly, and other filings with the SEC.

Section 10(b)[5] of the 1934 act is the general anti-fraud provision and the provision most frequently used by plaintiffs to allege securities fraud. Rule 10b-5,[6] issued to carry out and give effect to Sction 10(b), makes it illegal "for any person ... [t]o make any untrue statement of a material fact or to omit to state a material fact."

Neither Section 10(b) nor Rule 10b-5 provides for a private cause of action for plaintiffs to sue. Over the years, courts have established that private plaintiffs, not just the SEC or the Department of Justice (DOJ), have the right to bring a cause of action for violation of Section 10(b) and Rule

---

[3] 15 U.S.C. §§ 77a *et seq*.

[4] 15 U.S.C. §§ 78a *et seq*.

[5] 15 U.S.C. § 78j(b). The provision states in pertinent part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> ...
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered ... any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

[6] 17 C.F.R. § 240.10b-5. Rule 10b-5 states:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

10b-5. *Kardon v. National Gypsum Company,*[7] a 1947 case from the Federal District Court for the Eastern District of Pennsylvania, may be the earliest case to find a private cause of action for plaintiffs to sue for fraud under section 10(b).[8] In the 1971 case, *Superintendent of Insurance of the State of New York v. Bankers Life and Casualty Company,*[9] the Supreme Court confirmed the private right of action[10] and since then has reaffirmed the right.[11]

To establish securities fraud under Section 10(b), a plaintiff must typically prove (1) a material misrepresentation or omission by the defendant; (2) scienter [knowledge]; (3) a connection between the misrepresentation or omission and the purchase or sale of a security; (4) reliance upon the misrepresentation or omission; (5) economic loss; and (6) loss causation.[12]

Class Action

Although an individual may bring a private right of action under Section 10(b), a class action, made up in a sense of many individuals combining their private rights of action into a class of plaintiffs, may be a stronger suit than several individual suits. In order for a securities fraud class action suit to go forward to consideration of the merits, the class of plaintiffs must be certified. There is no presumption of class certification. In order to achieve class certification in the securities area, indeed in any area of law, certain requirements must be met.

Rule 23 of the Federal Rules of Civil Procedure (FRCP) sets out requirements that class actions must meet. One of the most important requirements for securities fraud class action certification, as it is for class certification in any area of law, is the predominance requirement of Rule 23(b)(3). For the predominance requirement to be met, questions of law or fact which are common to class members [must] predominate over any questions which affect only individual members.[13]

---

[7] 73 F. Supp. 798 (E.D. Pa. 1947).

[8] "On a motion to dismiss this Court held that, although not expressly provided for in the Statute, a remedy by civil action to enforce such duties and liabilities was available to the plaintiffs. The duty created is that of disclosure and the complaint and the evidence show that this suit was brought to enforce that liability. The liability to account for profits is the liability attendant upon the breach of that duty." *Id*. at 800.

[9] 404 U.S. 6 (1971).

[10] "Section 10(b) must be read flexibly, not technically and restrictively. Since there was a 'sale' of a security and since fraud was used 'in connection with' it, there is redress under § 10(b).... " *Id.* at 12.

[11] *See, e.g.,* Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc., 552 U.S. 148 (2008).

[12] *Id*.

[13] FRCP 23(b)(3) states,

> [T]he court [must] find that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy. The matters pertinent to these findings include
>
> (A) the class members' interests in individually controlling the prosecution or defense of separate actions;
>
> (B) the extent and nature of any litigation concerning the controversy already begun by or against class members;
>
> (C) the desirability or undesirability of concentrating the litigation of the claims in the particular forum; and
>
> (D) the likely difficulties in managing a class action.

General Telephone Company of the Southwest v. Falcon,[14] although not dealing with securities fraud, is perhaps the case best known for setting out the predominance requirement. The Supreme Court in *General Telephone* did not allow the certification of a class action brought by persons claiming discrimination in promotion based on national origin and persons claiming discrimination in hiring based on national origin. In its decision, the Court emphasized that, to be successful in achieving class certification, the class must satisfy Rule 23(b)'s requirement that "questions of law or fact common to class members [must] predominate over any questions affecting only individual members."[15]

Wal-Mart Stores, Inc. v. Dukes, also not a securities fraud class certification case but decided thirty years after *General Telephone*, used much the same rationale that was used in *General Telephone* for denying class certification. The Court stated,

> Rule 23 does not set forth a mere pleading standard. A party seeking class certification must affirmatively demonstrate his compliance with the Rule—that is, he must be prepared to prove that there are in fact sufficiently numerous parties, questions of law or fact, etc.┐

In the area of securities fraud class action certification, *Basic v. Levinson*[16] discussed the predominance requirement. The Supreme Court stated:

> The District Court adopted a presumption of reliance by members of the plaintiff class upon petitioners' public statements that enabled the court to conclude that common questions of law or fact predominated over particular questions pertaining to individual plaintiffs.┐

What is especially important about *Basic* is that the Court stated that the requirement of reliance may be met in some circumstances by allowing a presumption of reliance on material misstatements, instead of requiring each plaintiff to prove direct reliance. "Misleading statements will therefore defraud purchasers even if the purchasers do not directly rely on the misstatements."[17] *Basic* introduced the fraud-on-the-market theory as the rationale behind the presumption of reliance in certain circumstances. The fraud-on-the-market theory is based on the

---

[14] 457 U.S. 147 (1982).

[15] The Court stated at 157-158:

> [T]he allegation that such discrimination has occurred neither determines whether a class action may be maintained in accordance with Rule 23 nor defines the class that may be certified. Conceptually, there is a wide gap between (a) an individual's claim that he has been denied a promotion on discriminatory grounds, and his otherwise unsupported allegation that the company has a policy of discrimination, and (b) the existence of a class of persons who have suffered the same injury as that individual, such that the individual's claim and the class claims will share common questions of law or fact and that the individual's claim will be typical of the class claims. [footnote omitted] For respondent to bridge that gap, he must prove much more than the validity of his own claim. Even though evidence that he was passed over for promotion when several less deserving whites were advanced may support the conclusion that respondent was denied the promotion because of his national origin, such evidence would not necessarily justify the additional inferences (1) that this discriminatory treatment is typical of petitioner's promotion practices, (2) that petitioner's promotion practices are motivated by a policy of ethnic discrimination that pervades petitioner's Irving division, or (3) that this policy of ethnic discrimination is reflected in petitioner's other employment practices, such as hiring, in the same way it is manifested in the promotion practices. These additional inferences demonstrate the tenuous character of any presumption that the class claims are "fairly encompassed" within respondent's claim.

[16] 485 U.S. 224 (1988).

[17] *Id.* at 242.

belief that, in an efficient, well-developed securities market, all material information about a company is available to the public and this information is reflected in the stock price. Courts will allow plaintiffs under the fraud-on-the-market theory to show a rebuttable presumption of reliance on material misstatements, instead of requiring all plaintiffs in all cases to prove direct reliance which would, according to the Supreme Court in *Basic*, pose an undue burden on plaintiffs.

Cases, notably the *Halliburton* cases, have set out additional parameters for securities fraud class certification. Discussed later in this report, they include proof of loss causation and proof of materiality only at the merits stage, not at the class certification stage, and the right of a defendant to rebut the *Basic* presumption of reliance at the class certification stage.

It should be noted that, in response to the belief that too many frivolous class action securities cases were being brought, particularly in the 1980s, Congress in the 1990s enacted two statutes. The stated reasons for bringing all of these lawsuits were varied—fraud, mismanagement, nondisclosure of material information—but practically all of the lawsuits involved the loss of money by shareholders of the corporation. Some of the lawsuits no doubt had merit, but others were deemed frivolous and were brought as a matter of course when, for example, the share value of the stock of a corporation went down for reasons having nothing to do with the culpability of corporate managers.

In 1995, Congress enacted the Private Securities Litigation Reform Act (PSLRA).[18] The PSLRA limits shareholder lawsuits in federal courts by such actions as the following: (1) having the court appoint a lead plaintiff determined to be the most capable of adequately representing the interests of class members; (2) prohibiting a person from being a lead plaintiff in any more than five class actions in a three-year period; (3) guaranteeing that plaintiffs receive full disclosure of settlement terms; (4) eliminating coverage of securities fraud by the Racketeer Influenced and Corrupt Organizations Act; (5) providing a safe harbor for forward-looking statements; (6) providing for proportionate liability; and (7) providing for auditor disclosure of corporate fraud.

The Securities Litigation Uniform Standards Act of 1998 (SLUSA)[19] was enacted in response to the perceived failure of the PSLRA to curb alleged abuses of securities fraud class action litigation. PSLRA had set out a framework for bringing securities fraud class action cases in federal courts. However, in many instances, plaintiffs circumvented PSLRA by bringing cases in state courts on the basis of common law fraud or other non-federal claims.

SLUSA attempted to make certain that plaintiffs not be able to avoid the PSLRA requirements by requiring a securities fraud case to be brought only in a federal court and only under a uniform standard if certain criteria are satisfied, among them the following: (1) The lawsuit is a covered class action; (2) The claim concerns a covered security; (3) The plaintiff alleges a misrepresentation or omission of a material fact; and (4) The misrepresentation or omission is made in connection with the purchase or sale of a covered security.

There has been considerable controversy concerning securities fraud class action certification. Passions run high among both supporters and opponents of class action certification over what standards should be met. Some believe that many securities fraud class actions are frivolous and

[18] P.L. 104-67, codified in a number of provisions of 15 U.S.C. §§ 78a *et seq.*

[19] P.L. 105-353, codified in a number of provisions of 15 U.S.C. §§ 78a *et seq.*

that the only winners are the attorneys who bring the suits and who reap large legal fees. These opponents of class actions argue that the lawsuits are often brought to pressure companies into large settlements because companies are afraid of the expenses associated with defending class action suits. People who support easing requirements for securities fraud class action suits believe that the suits are necessary to hold companies accountable and that, otherwise, companies will be more likely to engage in fraudulent behavior with the belief that plaintiffs will be reluctant to risk the costs associated with certification and suing on the merits. Lawsuits have been brought, settlements have been reached, and federal statutes have been enacted, but the issue of securities fraud class action certification is far from being settled. The Halliburton cases will make this clear.

Halliburton Cases

Federal District Court Decision—I

The Erica P. John Fund (Fund), which exists to support the Archdiocese of Milwaukee, originally brought suit against Halliburton in 2002, with accusations that Halliburton had committed securities fraud in violation of Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission (SEC) Rule 10b-5 by understating its asbestos liabilities, overstating its revenues by including billings whose collections were unlikely, and exaggerating cost savings and efficiencies derived from a 1998 merger. Plaintiffs alleged that the misrepresentations inflated the price of Halliburton stock and that, when the truth was later revealed, the stock price dropped and they lost money.

In September 2007, the Fund moved to certify a class of persons who owned Halliburton stock during the appropriate time period. In an unpublished opinion, the Federal District Court for the Northern District of Texas declined to certify the class to bring the lawsuit on the basis that the plaintiffs had not proved reliance (one of the necessary elements for proving a Section 10(b) claim, as mentioned above) on material misstatements made by Halliburton.

Fifth Circuit Decision—I

The U.S. Court of Appeals for the Fifth Circuit (Fifth Circuit) affirmed.[20] In its decision, the Fifth Circuit began its analysis by stating that the case involved a private fraud-on-the-market allegation. The fraud-on-the-market theory, as discussed earlier, was set out in the Supreme Court case *Basic, Inc. v. Levinson.* It is based on the assumption that, in an efficient, well-developed securities market, all material information about a company is available to the public and that this information is reflected in the stock price. In order to use the fraud-on-the-market presumption of reliance, according to the Fifth Circuit, a plaintiff must show that an alleged misstatement "actually moved the market."[21] The court stated that it was necessary for the plaintiff to show loss causation and to show it "at the class certification stage by a preponderance of all admissible evidence."[22] In addition, the court required that the plaintiff show that the decline in the stock's

[20] The Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co., 597 F.3d 330 (5th Cir. 2010).

[21] Oscar Private Equity Investments v. Allegiance Telecom, Inc. 487 F.3d 261, 269 (5th Cir. 2007).

[22] *Id.*

price actually resulted from the disclosure of the truth concerning the earlier misstatements rather than from the release of unrelated negative information. In response to the plaintiff's claim that it had identified specific misrepresentations by Halliburton and that it had linked those misrepresentations, at least partially, to corrective disclosures, the Fifth Circuit stated that it was unconvinced. After going through the plaintiff's claims of Halliburton's misrepresentations and finding fault with all of the plaintiff's arguments about their impact on the decline of the stock price once Halliburton had issued corrective statements, the court concluded that the plaintiff had failed to meet the Fifth Circuit's requirements for proving loss causation at the class certification stage.

Supreme Court Decision—I

The Supreme Court in 2011 reversed the Fifth Circuit's decision. In *Erica P. John Fund, Inc. v. Halliburton Co.*,[23] the Court began its opinion by stating what is required to prevail on the *merits* in a private securities fraud action:

> To prevail on the merits in a private securities fraud action, investors must demonstrate that the defendant's deceptive conduct caused their claimed economic loss. This requirement is commonly referred to as "loss causation."┐

In contrast, the question presented to the Court in this case and in the lower court cases was whether securities fraud plaintiffs had to prove loss causation for *class certification*. The merits of the plaintiffs' case were not at issue. What was at sole issue, according to the Court, was whether the plaintiffs satisfied the class action certification predominance requirement of FRCP 23(b)(3).

In determining whether the FRCP 23(b)(3) requirement of common questions of law or fact has been met, the element of reliance by a plaintiff must often be examined. The Court discussed how, in *Basic v. Levinson*, it had recognized that requiring a plaintiff to demonstrate that he was actually aware of a company's statement and engaged in purchasing stock based upon that statement would be too limiting and "would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market."[24] Thus, in *Basic*, as discussed earlier, the Court allowed the plaintiffs to invoke a rebuttable presumption of reliance based on the fraud-on-the-market theory.[25]

The Supreme Court concluded by stating that the Court of Appeals erred when it required the Erica P. John Fund to prove loss causation at the certification stage. The Court refused to address

---

[23] No. 09-1403, 563 U.S. ___ (2011).

[24] Basic v. Levinson, 485 U.S. 224, 242 (1988).

[25] At 245-248, the Court in *Basic* stated:

> The presumption of reliance employed 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 markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets....
>
> The presumption is also supported by common sense and probability. Recent empirical studies have tended to confirm Congress' premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations. [footnote omitted] It has been noted that "it is hard to imagine that there ever is a buyer or seller who does not rely on market integrity. Who would knowingly roll the dice in a crooked crap game.... " [citation omitted]
>
> Any showing that severs 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.

any other questions which Halliburton might have, such as the presumption of reliance under the fraud-on-the-market theory or how and when the presumption might be rebutted. The Supreme Court vacated the judgment of the Fifth Circuit and remanded it for further proceedings consistent with the opinion.

Federal District Court Decision—II

On remand, Halliburton argued that the class should still not be certified because it had discovered evidence that the alleged fraud did not affect the market price of the stock. Halliburton contended that, by demonstrating the absence of any "price impact,"[26] it had complied with the guidance set out in *Basic* that a defendant must have the opportunity to rebut the presumption of reliance allowed by the fraud-on-the-market theory. Without the benefit of the *Basic* presumption, according to Halliburton, investors would have to prove reliance on an individual basis; thus, individual issues would predominate over common ones, precluding class certification.

According to statements in the decision later issued by the Fifth Circuit, the district court on remand declined to consider the evidence which Halliburton claimed to have discovered. The district court found that the price impact evidence did not have a bearing on the important issue of whether common issues predominated so as to satisfy FRCP 23(b)(3). Instead, believing that common issues predominated and that the other requirements of Rule 23 were met, the district court certified the class.

Fifth Circuit Decision—II

Halliburton appealed to the Fifth Circuit, and in April 2013 the Fifth Circuit in *Erica P. John Fund, Inc. v. Halliburton Co.*[27] affirmed the district court's decision to certify the class. Only two months before the Fifth Circuit's decision, the Supreme Court decided another case, *Amgen, Inc. v. Connecticut Retirement Plans (Amgen),*[28] which the Fifth Circuit referenced in the *Halliburton* decision.

In *Amgen*, the Supreme Court held that a plaintiff in a securities fraud Section 10(b) case is not required to prove prior to certification of a class action that a defendant made a material misstatement. The case resolved a significant split among the federal circuit courts on the issue of whether proof of materiality (reliance upon a material[29] misstatement or omission) is required for class certification.[30]

---

[26] "Price impact" is the effect of a misrepresentation on a stock price.

[27] 718 F.3d 423 (2013).

[28] No. 11-1085, 568 U.S. ___ (2013).

[29] Courts have sketched out a definition of material information as information that a reasonable investor would need to make an informed investment decision. *See, e.g.,* TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976) and Mills v. Electric Auto-Lite Co., 396 U.S. 375 (1970).

[30] Over the years, cases, notably *Matrixx Initiatives, Inc. v. Siracusano* (No. 09-1156, 563 U.S. ___ (2011), have established the requirement that a plaintiff must prove in a securities fraud claim that there was reliance upon a material misstatement or omission by the defendant. As stated above, in *Basic* the Supreme Court endorsed a fraud-on-the-market theory allowing a plaintiff in an efficient market to invoke a rebuttable presumption of reliance upon a public, material misrepresentation. Connecticut Retirement in *Amgen* invoked the fraud-on-the-market theory in seeking class action certification under FRCP 23(b)(3) against Amgen for alleged material misstatements. Amgen defended that Connecticut Retirement had not proved the misstatements to be material and could not therefore be certified as an (continued...)

After discussing the *Amgen* case, the Fifth Circuit examined Halliburton's claim that the question before the court was whether price impact was an issue which a defendant might use at class certification in order to rebut the fraud-on-the-market presumption that the stock price was affected by a misstatement that was later corrected. Halliburton argued that, in spite of the proof provided to support invoking the fraud-on-the-market presumption of reliance, its own evidence showed that the misrepresentation did not actually have an impact on the price which the purchaser paid for the stock. The Fifth Circuit agreed with Halliburton that, if there was no price impact, then that evidence could be used at the trial *on the merits* to refute the fraud-on-the-market reliance of presumption. Although the Fifth Circuit believed that the Supreme Court in *Amgen* did not discuss whether this evidence could be considered at *class certification*, the Fifth Circuit stated that the Supreme Court did provide a framework for resolving the question. That framework, according to the Fifth Circuit, was based simply on whether resolution of the matter was necessary for determining whether questions of law or fact common to the class would predominate over questions affecting only individual members.

The Fifth Circuit then examined whether price impact evidence was common to the class and whether there was any risk that a later failure to prove the common question of price impact would result in the predominance of individual questions. The Fifth Circuit disagreed with Halliburton's argument that in this particular case the plaintiff class could not show price impact and should lose the class-wide presumption of reliance, leaving individuals, according to Halliburton, with possibly still viable fraud claims which they could pursue on an individual basis. According to the Fifth Circuit, if Halliburton could successfully rebut the fraud-on-the-market presumption by showing no price impact, not only could there be no class certification but the individual plaintiffs would also have no claims because they could not establish loss causation, an essential element of a Section 10(b) fraud action. Thus, the Fifth Circuit affirmed

---

(...continued)

appropriate class.

In holding that proof of materiality is not required for certification of a securities fraud class action, the Court reasoned that the plaintiffs' assertion was sufficient for the purpose of class certification because at that particular stage of the proceedings the issue was not whether there had actually been a material misstatement or omission by the defendant. The Court believed that that determination could occur at a later time when the certified class presented its evidence of material misstatements to a court. The Supreme Court was not persuaded by Amgen's rebuttal argument that policy considerations militated in favor of proof of materiality because class certification might place pressure on a defendant to settle rather than to risk significant costs in defending its actions. The Court believed that the pivotal inquiry in the case was whether proof of materiality was necessary to satisfy the requirement of Rule 23(b)(3) that questions of law or fact common to the class would predominate over any individual questions of law or fact. The Court stated,

> The District Court did not err, we agree with the Court of Appeals, by disregarding Amgen's rebuttal evidence in deciding whether Connecticut Retirement's proposed class satisfied Rule 23(b)(3)'s predominance requirement. The Court of Appeals concluded, and Amgen does not contest, that Amgen's rebuttal evidence aimed to prove that the misrepresentations and omissions alleged in Connecticut Retirement's complaint were immaterial.... As explained above, however, the potential immateriality of Amgen's alleged misrepresentations and omissions is no barrier to finding that common questions predominate.... If the alleged misrepresentations and omissions are ultimately found immaterial, the fraud-on-the-market presumption of classwide reliance will collapse. But again, as earlier explained ... , individual reliance questions will not overwhelm questions common to the class, for the class members' claims will have failed on their merits, thus bringing the litigation to a close. Therefore, just as a plaintiff class's inability to prove materiality creates no risk that individual questions will predominate, so even a definitive rebuttal on the issue of materiality would not undermine the predominance of questions common to the class. No. 11-1085, 568 U.S. ___, slip op. at 11.

the district court decision, concluding that price impact fraud-on-the-market rebuttal evidence could *not* be addressed at class certification. The Court stated,

> Proof of price impact is based upon common evidence, and later proof of no price impact will not result in the possibility of individual claims continuing. Accordingly, Halliburton's price impact evidence does not bear on the question of common question predominance, and is thus appropriately considered only on the merits after the class has been certified.[31]

Supreme Court Decision—II

Halliburton filed a writ of certiorari with the Supreme Court. The Court granted the petition, and on June 23, 2014, the Court issued its decision, *Halliburton Co. v. Erica P. John Fund, Inc.* The Court in its decision could have invalidated the fraud-on-the-market theory and overruled *Basic,* or it could have prevented the defendants from being allowed to rebut evidence at the class certification stage. It did neither; instead, it chose a middle ground, giving, in a sense, something to everyone but everything to no one. The Court decided, with respect to the first question stated at the beginning of this report, not to overrule the presumption of reliance provided by the fraud-on-the-market theory but that, with respect to the second question, defendants in a class action may attempt to rebut the presumption of reliance at the class certification stage by introducing evidence that the alleged misrepresentations did not distort the market price of its stock. Chief Justice Roberts wrote the opinion and was joined by Justices Kennedy, Ginsburg, Breyer, Sotomayor, and Kagan.

The Court first examined Halliburton's argument to overrule the presumption of reliance in *Basic*, thereby requiring every securities fraud plaintiff to prove actual reliance on the defendant's misrepresentation when deciding whether to buy or sell a company's stock. The Court stated that before overturning a long-settled precedent, it must, according to *Dickerson v. United States*,[32] find "special justification," not simply an argument that the precedent was "wrongly decided."

The Court then recapped its rationale and holding in *Basic v. Levinson*. According to the fraud-on-the-market theory developed in *Basic*, when an investor buys or sells stock at the market price, his reliance on any public material misrepresentations may be presumed for a securities fraud action. Based on this theory, the *Halliburton* Court emphasized, a securities fraud plaintiff must show: 1. that the alleged misrepresentations were publicly known; 2. that they were material; 3. that the stock traded in an efficient market; and 4. that the plaintiff traded the stock between the time that the misrepresentations were made and when the truth was disclosed. *Basic* also made clear that the presumption of reliance was rebuttable and not conclusive.

> Any 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.[33]

Halliburton argued before the Supreme Court that securities fraud plaintiffs should always be required to prove direct reliance and that the Supreme Court in *Basic* mistakenly allowed plaintiffs to invoke a presumption of reliance. Halliburton claimed that the *Basic* presumption is

---

[31] 718 F.3d 423, 435 (2013).

[32] 530 U.S. 428 (2000).

[33] 485 U.S. 224, 248 (1988).

opposed to Congress's intent in the Securities Exchange Act and that subsequent developments in economic theory have undermined the *Basic* presumption. The Court concluded that neither of these arguments constituted "special justification" for overruling *Basic*.

With respect to the argument that the *Basic* presumption contravened congressional intent in the Securities Exchange Act, Halliburton stated that the private right of action under Section 10(b) is a judicial construct that Congress did not enact and that the Court must identify some provision from the Securities Exchange Act which does provide for a private right of action and interpret any private right of action allowed under Section 10(b) in an analogous way. The provision which Halliburton identified as most similar was Section 18(a),[34] which creates a private right of action for investors to allow recovery of damages based on misrepresentations in regulatory filings. That provision requires an investor to prove that he bought or sold stock by relying upon a defendant's misrepresentation. The defendant disputed Halliburton by arguing that Congress has actually affirmed *Basic*'s construction of Section 10(b) and that, further, Section 9 of the Securities Exchange Act,[35] which does not require actual reliance, is the closest analogue to Section 10(b). The Supreme Court stated that Halliburton's argument had been made in *Basic* and that it was unconvincing then and unconvincing now.

Halliburton then argued that the economic premises upon which *Basic* rested—the "robust view of market efficiency" and investor reliance upon the integrity of the marketplace—are no longer tenable. The Court refuted these arguments by stating that the *Basic* decision did not rest upon a binary view of market efficiency but, rather, that it recognized that market efficiency is a matter of degree. Further, *Basic* did not state that *all* investors rely upon the integrity of the marketplace but that, instead, it is reasonable to presume that *most* investors rely upon the security's price as an assessment of its value in light of all publicly available information.

The Court next discussed that the principle of *stare decisis* (the doctrine of precedent) has "special force" in the interpretation of statutes because of the fact that at any time Congress may undo a court decision by enacting legislation.[36] The Court mentioned other decisions, such as *Central Bank of Denver, N.A. v. First Interstate Bank of Denver*[37] and *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*,[38] which have dealt with the Section 10(b) cause of action, and found no inconsistency between them and the presumption of reliance allowed in *Basic*.

---

[34] 15 U.S.C. § 78r(a).

[35] 15 U.S.C. § 78i.

[36] The Court stated at page 13 of the slip opinion:

> The principle of *stare decisis* has "special force" in respect to statutory interpretation because Congress remains free to alter what we have done. [citations and quotations omitted] So too with *Basic*'s presumption of reliance. Although the presumption is a judicially created doctrine, designed to implement a judicially created cause of action, we have described the presumption as "a substantive doctrine of federal securities-fraud law." *Amgen*, *supra*, at ___ (slip op., at 5). That is because it provides a way of satisfying the reliance element of the Rule 10b-5 cause of action. [citation omitted] As with any other element of that cause of action, Congress may overturn or modify any aspect of our interpretations of the reliance requirement, including the *Basic* presumption itself. Given that possibility, we see no reason to exempt the *Basic* presumption from ordinary principles of *stare decisis*.

[37] 511 U.S. 164 (1994).

[38] 552 U.S. 148 (2008).

The Court also discussed recent decisions such as *Wal-Mart Stores, Inc. v. Dukes*, which have governed class action certification and the requirement that plaintiffs prove that their class satisfies FRCP 23. It found that the *Basic* presumption of reliance did not relieve plaintiffs from meeting the class certification requirements and that Halliburton's claims that the *Basic* presumption leads to unnecessary lawsuits should be addressed by Congress. In fact, according to the Court, Congress did address some of the securities class action frivolous lawsuit concerns in the Private Securities Litigation Reform Act and the Securities Litigation Uniform Standards Act, discussed earlier in the report.

Halliburton proposed two alternatives to overruling *Basic*. The first alternative would require that a plaintiff actually *prove* that a defendant's misrepresentation affected the stock price ("price impact") before invoking the *Basic* presumption of reliance. The Court found this alternative unacceptable for the same reasons that it refused in general to overrule *Basic*'s presumption of reliance. As stated before, according to *Basic*, if a plaintiff can show that the defendant's misrepresentation was publicly known and material, that the stock traded in an efficient market, and that the plaintiff traded the stock between the time when the misrepresentations were made and the truth was revealed, he is allowed to invoke the *Basic* presumption of reliance. If a plaintiff were required to prove, as Halliburton urged, price impact directly, he would be foreclosed from showing that the stock was trading in an efficient market, thus overruling an important element set out by *Basic* in its presumption of reliance doctrine.

Halliburton's second proposed alternative would allow a defendant to rebut the *Basic* presumption of reliance by showing a *lack* of price impact and to show the lack of price impact not only at the merits stage but, more importantly according to Halliburton, *before* the class is certified. If a defendant were able to show a lack of price impact at the time that the class is arguing for certification, Halliburton claimed, it could prevent the class from being certified.

The Supreme Court was receptive to Halliburton's second proposed alternative to overruling *Basic*. According to the Court, it makes no sense to forbid defendants from using the same evidence about price impact before class certification that they would be able to use at the merits stage to rebut the presumption of reliance. The Court stated that this prohibition would actually be inconsistent with its decision in *Basic*.[39]

The Court disagreed with the Fifth Circuit's interpretation of *Amgen* as not allowing the consideration of price impact fraud-on-the-market rebuttal evidence at class certification. *Amgen*, according to the Supreme Court in *Halliburton II*, held that, although materiality is required for

---

[39]The Court stated at pages 18-19 of the slip opinion:

> There is no dispute that defendants may introduce such evidence at the merits stage to rebut the *Basic* presumption. *Basic* itself "made clear that the presumption was just that, and could be rebutted by appropriate evidence," including evidence that the asserted misrepresentation (or its correction) did not affect the market price of the defendant's stock. [citation omitted]
>
> Nor is there any dispute that defendants may introduce price impact evidence at the class certification stage, so long as it is for the purpose of countering a plaintiff's showing of market efficiency, rather than directly rebutting the presumption. As EPJ Fund acknowledges, "[o]f course ... defendants can introduce evidence at class certification of lack of price impact as some evidence that the market is not efficient." [citations omitted]
>
> After all, plaintiffs themselves can and do introduce evidence of the existence of price impact in connection with "event studies"—regression analyses that seek to show that the market price of the defendant's stock tends to respond to pertinent publicly reported events. [citation omitted]

invoking the *Basic* presumption of reliance, the question of whether material misrepresentation actually occurred should be left to the merits stage of the case. However, the *Amgen* decision did not forbid, for purposes of class certification, the presenting of evidence that an alleged misrepresentation did not affect the price of the stock. In fact, according to the Court in *Halliburton II*, in order to maintain the consistency of the presumption of reliance as set out in *Basic* with the class certification requirements of FRCP 23, defendants must have the opportunity before the class is certified to provide evidence that an alleged misrepresentation did not affect the price of the stock.[40]

The Court vacated the Fifth Circuit's judgment and remanded the case for further proceedings consistent with the opinion.

Justice Ginsburg, joined by Justices Breyer and Sotomayor, wrote a brief concurring opinion, stating that "it is incumbent upon the defendant to show the absence of price impact," thereby imposing "no heavy toll on securities fraud plaintiffs with tenable claims."[41]

Justice Thomas, joined by Justices Scalia and Alito, filed an opinion concurring in the judgment but calling for overruling *Basic*.[42]

Conclusion

It appears that over the past thirty years the Supreme Court has struck something of a middle ground in setting out the parameters for securities fraud class action certification, finding for neither plaintiffs nor defendants in all challenges. The Court has held that there must be predominance of common issues of fact or law (*General Telephone Company of the Southwest v. Falcon,* as affirmed by *Basic v. Levinson*), a burden which plaintiffs must meet. Presuming reliance on material misstatements is allowed under certain circumstances (*Basic v. Levinson*), a development opposed by defendants, who have argued for direct reliance. Limiting or eliminating proof of materiality at the class certification stage (*Amgen, Inc. v. Connecticut Retirement Plans)* is another development which defendants opposed. Not having to prove loss causation at the class certification stage (Supreme Court's first *Halliburton* decision) was another favorable decision for class action plaintiffs. Requiring proof of market efficiency (*Basic v. Levinson)* is a burden

[40] The Court stated at page 22 of the slip opinion:

> Price impact is different [from materiality]. The fact that a misrepresentation "was reflected in the market price at the time of [the] transaction"—that it had price impact—is "Basic's fundamental premise." [citation omitted] It thus has everything to do with the issue of predominance at the class certification stage. That is why, if reliance is to be shown through the Basic presumption, the publicity and market efficiency prerequisites must be proved before class certification. Without proof of those prerequisites, the fraud-on-the-market theory underlying the presumption completely collapses, rendering class certification inappropriate.

[41] *Id*., Ginsburg, R., concurring, at 1.

[42] At page 18 of his concurring opinion, Justice Thomas stated,

> Basic took an implied cause of action and grafted on a policy-driven presumption of reliance based on nascent economic theory and personal intuitions about investment behavior. The result was an unrecognizably broad cause of action ready made for class certification. Time and experience have pointed up the error of that decision, making it all too clear that the Court's attempt to revise securities law to fit the alleged "new realities of financial markets" should have been left to Congress. [citation omitted]

which the plaintiffs may find difficult at times to meet. Allowing defendants at the class certification stage to rebut the presumption of reliance (*Basic v. Levinson)* is a decision which plaintiffs may oppose.

In the same way, the Supreme Court struck a kind of middle ground in its decision of *Halliburton II*. The Court did not overrule *Basic v. Levinson* and its fraud-on-the-market theory which allows a presumption of reliance, rather than required direct reliance, under certain circumstances, but the Court did allow defendants to rebut this presumption of reliance at the class certification stage by introducing evidence that the alleged misrepresentations did not distort the stock's market price. *Basic* had stated that the defendants could rebut the presumption of reliance, and in *Halliburton II* the Court recognized that one way to rebut the presumption of reliance is to show an absence of price impact caused by defendant's alleged misstatements.

Despite the Court's not jettisoning the fraud-on-the-market reliance presumption of reliance set out in *Basic*, some commenters believe that defendants achieved a significant victory in *Halliburton II*. An attorney who represented Halliburton stated that "[T]he defense has argued for the ability to rebut the presumption with price impact evidence since the case went up to the court the first time in 2010."[43] When she stated that the defendant has the burden of showing the *absence* of price impact, Justice Ginsburg in her brief concurring opinion may have anticipated that many will believe that the *Halliburton II* decision will make class action certification more difficult.

The *Halliburton II* decision has already begun to have an impact on class certification. In a case decided not long after *Halliburton II*, the U.S. Court of Appeals for the Eleventh Circuit on August 6 vacated the certification of a plaintiff class in a lawsuit brought against Regions Financial Corporation so that the lower court could consider Regions' evidence of lack of price impact caused by allegedly fraudulent statements about real estate investments.[44]

Halliburton II is not the end of the *Erica P. John Fund v. Halliburton* saga. It may not even be the end of the class certification challenges. A major issue for class certification after *Halliburton II* now seems to be what kind of evidence is sufficient for defendants to show that the alleged misstatements had no price impact on the stock. Will it, for instance, be necessary to show results of econometric studies and will these studies be rebuttable by the involved parties? Finally, once the class is finally certified, the courts may then face the merits of the case. It seems that another ten years could easily pass before final resolution occurs.

Author Contact Information

Michael V. Seitzinger
Legislative Attorney
mseitzinger@crs.loc.gov, 7-7895

[43] http://www.bna.com/halliburton-lawyer-case-n17179893183.

[44] Local 703, I.B. of T. Grocery & Food Employees Welfare Fund v. Regions Financial Corporation, No. 12-14168 (11th Cir. Aug. 6, 2014).