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How the Supreme Court's Upcoming *Halliburton* Decision on the Fraud-on-the-Market Presumption May Impact Securities Litigation

In June, the United States Supreme Court will decide whether the fraud-on-the-market presumption should be overruled or modified. For the last quarter century, securities plaintiffs have relied on this presumption to successfully prosecute securities class actions that have resulted in substantial recoveries against publicly traded companies and the D&O insurance industry. In fact, class certification was denied based on the merits in less than 2% of securities actions filed between 2002 and 2010. Cornerstone Research & Stanford Law School Securities Class Action Clearinghouse, *Securities Class Action Filings: 2013 Year in Review, 2014*, at 9. The consensus of industry experts is that a decision from the Supreme Court overruling or substantially modifying the fraud-on-the-market presumption will stand as a major impediment to the ability of securities plaintiffs' firms to continue to achieve these results. However, this impediment will not leave plaintiffs' firms dead in the water. To the contrary, as they have done in the past with previous securities law reforms, the plaintiffs' bar will likely adjust in a meaningful way.

A Background on the Fraud-on-the-Market Presumption

In order for securities plaintiffs to obtain class certification, they must satisfy Rule 23 of the Federal Rules of Civil Procedure. Among other things, Rule 23 requires that the questions of law or fact common to class members predominate over any questions affecting only individual members. Fed. R. Civ. P. 23(b)(3). This requirement becomes more of an issue in the context of satisfying the reliance element of a Rule 10b-5 claim. The predominance issue generally depends on whether the fraud-on-the-market presumption is available to securities plaintiffs. Without this presumption, plaintiffs' counsel would be required to demonstrate that each member of the putative class actually considered and believed the misrepresentation. Given that most investors are not aware of statements made by the companies whose stock they purchased and because the existence of thousands or tens of thousands of class members, this process would be unduly burdensome.

The Supreme Court endorsed the fraud-on-the-market presumption in *Basic v. Levinson*, 485 U.S. 224 (1988). The Court recognized that requiring a Rule 10b-5 plaintiff to show how he would have acted in the absence of the misrepresentation would create an "unnecessarily unrealistic evidentiary burden." *Id.* at 245. Accordingly, the Court permitted the use of a rebuttable presumption of reliance based on the fraud-on-the-market theory. The fraud-on-the-market theory is based on the hypothesis that, in an open and developed securities market, the price of a company's stock is determined by the available material information regarding the company and its business, and misleading statements will therefore defraud stock purchasers even if investors do not directly rely on the misstatements. *Id.* at 241-42. According to *Basic*, an investor who buys or sells stock at the price set by the market does so in reliance on the integrity of that price, and because all publicly available information is reflected in the market price, an investor's reliance on any public material misrepresentations may be presumed for purposes of a Rule 10b-5 action. *Id.* at 247. As this is only a presumption of reliance, the Court explained that any showing severing the link between the alleged misrepresentation and either the stock price or the investor's decision to trade would be sufficient to rebut the presumption. *Id.* at 248.

Therefore, *Basic* has provided a framework for securities plaintiffs to avoid having to prove that each individual investor relied on the alleged misrepresentations, provided that the stock traded in an efficient market where the price reflected all publicly available information. While the fraud-on-market presumption is still subject to challenge after class certification during the summary judgment and trial phases, most securities class actions settle even before class certification is tested on the merits, often during the pleadings stage or soon after the plaintiffs' claims survive the pleading stage. In fact, with respect to all securities class actions filed and resolved between 2000 and 2013, 73% were either settled or dismissed prior to the filing of a motion for class certification, and a decision on a class certification motion was reached in only 15% of all securities actions filed during this time. Dr. Renzo Comolli & Svetlana Starykh, *Recent Trends in Securities Class Action Litigation: 2013 Full-Year Review*, NERA Economic Consulting, Jan. 21, 2014, at 19. Thus challenging the presumption after class certification has had little to no effect on securities class action litigation.

In recent years, two other U.S. Supreme Court decisions addressed the fraud-on-the-market presumption. First, in *Erica P. John Funds, Inc. v. Halliburton Co.* (a previous Supreme Court decision in the same *Halliburton* lawsuit), the Court unanimously held that the plaintiff was not required to prove loss causation at the certification stage. 131 S. Ct. 2179, 2187 (2011). Then, in *Amgen Inc. v. Connecticut Retirement Plans and Trust Funds*, while the Court acknowledged that materiality is indisputably an essential predicate of the fraud-on-the-market theory, it concluded that proof of materiality is not needed to ensure that the *questions* of law or fact common to the class will predominate over any questions affecting only individual members for purposes of certifying a class. 133 S. Ct. 1184, 1195 (2013). The Court in *Amgen* also held that rebuttal evidence on the issue of materiality would not undermine the predominance of questions common to the class, and therefore such rebuttable evidence should be reserved for summary judgment or trial. *Id.* at 1203-04. Notably, the concurring and dissenting opinions in *Amgen* expressed reservations regarding the fraud-on-the-market theory and questioned the validity of *Basic*.

The Forthcoming *Halliburton* Decision

Now, the Supreme Court has granted certiorari to resolve certain issues that arose on remand in the *Halliburton* case. The specific questions presented on appeal are (1) whether the Court should overrule or substantially modify the holding of *Basic* to the extent that it recognizes a presumption of class-wide reliance derived from the fraud-on-the-market theory; and (2) whether, in a case where the plaintiff invokes the presumption of reliance to obtain class certification, the defendant may rebut the presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock.

In its brief, Halliburton argues that the Supreme Court should overrule *Basic* essentially because its "simplistic understanding of market efficiency is at war with economic realities" and "massively expands 10b-5 liability in stark contrast to the Court's consistent holdings that the judicially created action must be narrowly construed." According to Halliburton, *Basic* also "undercuts the Court's insistence that plaintiffs invoking Rule 23 must *affirmatively show* that common issues predominate, not presume they do." Alternatively, Halliburton contends the Court should at least substantially modify the threshold for invoking its presumption of reliance. Halliburton argues that, since stock prices do not efficiently incorporate all types of information at all times even in well-developed markets, "plaintiffs seeking class certification should be required to prove that the alleged misrepresentation *actually* distorted the market price," thereby more closely aligning the reliance presumption with economic reality and with Rule 23's requirement that common issues predominate.

Lead Plaintiff, Erica P. John Funds, Inc. (" Fund"), in its respondent brief, argues that *Basic* is well-settled, explaining that the Supreme Court has repeatedly cited its holding favorably and that, for decades, the SEC has consistently supported private securities actions employing the *Basic* framework as an essential supplement to federal securities enforcement efforts. Both corporate directors and officers and institutions purportedly have relied on *Basic*'s deterrent effect. The Fund further contends that Congress had expressly considered overturning *Basic* and could have done so at any time over the past quarter century. Instead, as argued, Congress left the *Basic* framework in place even when imposing rigorous standards on pleading securities fraud actions and the appointment of lead counsel for example. The Fund goes on to argue that, "[n]ot only is the question of whether to overrule *Basic* the prerogative of Congress under well-established principles of *stare decisis*, but *Basic* was correctly decided." According to the Fund, *Basic* itself makes clear that the economic debate over the efficient capital market hypothesis is irrelevant because even critics of the hypothesis uniformly accept that stock prices generally react reasonably promptly to material, public information. The Fund explains that *Basic* accounts for the fact that not all markets are efficient by requiring plaintiffs to submit proof sufficient to trigger the presumption and by permitting defendants to rebut it. The Fund also disputes Halliburton's alternative arguments. The Fund challenges the notion of requiring proof of price impact at the class certification stage as an improper attempt to insert a merits inquiry into the class certification process. The Fund also contests the suggestion of permitting defendants to rebut the presumption with evidence of lack of price impact at the class certification stage, explaining that rebuttal is a matter for trial and allowing for this would conflict with Rule 23 and the *Amgen* decision.

Halliburton's Potential Impact on Securities Litigation

There are several potential implications of the Supreme Court's forthcoming second *Halliburton* decision. First, if *Halliburton* overturns *Basic* and no longer permits reliance to be presumed based on the fraud-on-the-market theory, securities plaintiffs will have a significantly more difficult task in obtaining class certification. Some commentators believe plaintiffs will no longer have the ability to certify classes in connection with Rule 10b-5 actions, and others have suggested the impact would limit the need for D&O liability insurance. However, we should not expect the plaintiffs' securities class action bar to shift their focus to practice areas outside the realm of securities litigation. Throughout history, the plaintiffs' bar has been extremely resilient and nimble, and we can expect the plaintiffs' bar, and in particular the leading plaintiffs' firms, to respond with additional creative strategies. The leading securities litigation firms have already shown their ability to adapt to previous efforts at securities law reforms, including heightened pleading standards and other procedural obstacles pursuant to the PSLRA, as well as SLUSA's limitations for securities class actions.

Certain Securities Claim Left Untouched by *Halliburton*

First, there are certain securities claims that will not be impacted even if *Halliburton* overturns *Basic*. For instance, we will not see any reduction in the frequency of Section 11 claims as a result of *Halliburton*. Section 11 expressly provides investors with a private right of action to seek damages in connection with a material untrue statement or omission in the registration statement required to be filed for any public offering of stock. Unlike in 10b-5 actions, plaintiffs need not prove reliance as an element of a Section 11 action. Accordingly, plaintiffs' firms will maintain an avenue to bring class actions for misrepresentations in IPOs and secondary offerings.

A rejection of the fraud-on-the-market presumption will not necessarily require plaintiffs to resort only to bringing Section 11 claims. We expect plaintiffs to continue filing 10b-5 suits on a class-wide basis. Reliance is an element of a 10b-5 claim based on an untrue statement of material fact; however, a plaintiff is not required to prove reliance when the 10b-5 claim is premised on a material omission. As explained by the Supreme Court in *Affiliated Ute Citizens of Utah v. United States*, when the circumstances primarily involve a failure to disclose, positive proof of reliance is not a prerequisite to recovery. 406 U.S. 128, 153 (1972). Instead, plaintiffs need only demonstrate that the facts withheld are material in the sense that a reasonable investor might have considered them important in the making of this decision. *Id.* at 154. The Supreme Court went on to explain that the obligation to disclose and the withholding of a material fact, alone without a showing of reliance, establish the element of causation in fact. *Id.* In other words, reliance can be presumed in the context of omissions without the need to resort to the fraud-on-the-market theory. Therefore, without the fraud-on-the-market presumption, plaintiffs seeking to certify a 10b-5 class will have an incentive to couch what would normally be viewed as an affirmative misrepresentation in terms of an omission. Of course, such attempts to re-characterize untrue statements as omissions will likely be challenged by defense counsel, and we anticipate increased litigation over this issue.

We should point out that if the new *Halliburton* decision only modifies the fraud-on-the-market presumption, securities plaintiffs may simply use the parameters set by the Supreme Court to plead reliance and possibly survive a motion to dismiss.

Efforts to Circumvent *Halliburton* Outside the Courts

Should *Halliburton* overturn *Basic*, the plaintiffs' securities class action bar also might respond by seeking to change the law. The plaintiffs' bar can attempt to do this in a number of ways. First, they can approach Congress to enact a law specifically recognizing the fraud-on-the-market presumption or specifically rejecting *Halliburton*, which likely would not be easy to accomplish. The plaintiffs' bar also could circumvent Congress entirely by seeking refuge from the SEC. For instance, plaintiffs' firms can request that the Commission amend Rule 10b-5 to recognize the fraud-on-the-market presumption, although the validity of this administrative law might be challenged if it directly contravenes the *Halliburton* decision. However, if *Halliburton* only limits the use of the presumption, the SEC alternatively may have wiggle room to provide guidance on the circumstances under which the presumption should apply. The plaintiffs' bar also might simply request that the SEC require companies to disclose whether or not their stock trades in an efficient market (for purposes of presuming reliance) in either their SEC filings or to be eligible for listing on a stock exchange.

Shift to Individual Lawsuits and State Law Claims

We also note that, even if we were to have a significant decline in new class action filings, the plaintiffs' bar may still effectively prosecute individual securities lawsuits that in and of themselves could allege significant damages. As a result of the changes in the selection of lead counsel brought about by the PSLRA, plaintiffs' firms have cultivated close ties with institutional investors and achieved substantial recoveries for these institutions. We should expect these institutional investors to pursue individual cases where they have sustained large losses. These individual suits may take the form of separate single-plaintiff suits or a non-class action on behalf of a group of investors. Multiple individual investor actions could be filed in different federal and state courts throughout the country. Also, with a reduction in securities class actions, we are likely to see more securities suits filed in state courts, effectively reversing some of the impact of the Class Action Fairness Act, which expanded federal jurisdiction for class actions. Without the Act's applicability, securities plaintiffs may return to the pre-Act days of forum-shopping in state court. Similarly, class actions are further limited by SLUSA, which preempts state and common law claims in securities class actions and also broadens federal jurisdiction over class actions. Therefore, without the need to comply with federal statutes concerning class actions, we should expect not only more suits filed in state court but also more state and common law causes of action relating to securities fraud. Defending multiple lawsuits in a number of different jurisdictions may lead to inconsistent results based on either different legal standards or simply a different judge. This new landscape also may result in plaintiffs' firms seeking larger fee awards to account for their additional time and expenses incurred in bringing multiple lawsuits and litigating novel issues that may arise from *Halliburton*'s impact. In turn, expectations of larger fee awards may translate to larger individual settlements, as plaintiffs' firm likely will only agree to a number they believe sufficiently compensates them for their efforts.

Although the exposure from one significant institutional investor is not as significant as the loss attributable to an entire class of investors, such settlements and judgments may still be sizeable. Over the last several years, there has been a trend of large institutional investors opting out of

class settlements in securities actions, particularly in litigation involving mortgage-backed securities. Large institutions that opt out of a class settlement typically will ultimately settle for a higher percentage of their investment loss as compared to the percentage of loss recovered through class settlement. Moreover, defending a series of lawsuits pending in multiple states may prove to be a more difficult and costly task than if the claims had been unified in a consolidated securities class action as part of the MDL process. Defending individual suits could be more expensive and more complicated in terms of the coordination of defense strategies, and achieving settlements through the mediation process would be exceedingly more difficult to accomplish.

Furthermore, public companies and their boards, as well as D&O insurers, prefer global peace from the class settlement mechanism. Class settlements are binding on members of the class that do not opt out of the class settlement, and most settlement agreements in securities class actions contain a low "blow" provision that makes the settlement contingent on very few opt outs. However, when an individual investor suit settles, the settlement has no binding effect on other putative class members. Instead, individual, non-class settlements may provide incentive for tag-along suits by other investors, particularly in the event the defendants were subject to an adverse decision, in which case other plaintiffs could seek to use the collateral estoppel doctrine to preclude the defendants from re-litigating the same issue in another lawsuit.

When faced with individual investor suits, in addition to difficulty in coordinating defense strategies and achieving consistent results, defendants also may have difficulty achieving consistent reasonable settlements. For instance, the amount of available D&O insurance could be an obstacle, as the defendants will attempt preserve limits for defense costs in certain cases while at the same time utilize available limits to achieve reasonable settlements. These circumstances would be similarly challenging when defendants seek settlement authority from their D&O carriers. The D&O carriers would be faced with the challenge of assessing appropriate settlement amounts without being able to necessarily predict the level of risk with respect to future related claims. Moreover, it might be more costly for insurance carriers to manage the claim process. As respects settlement, the carriers, like their policyholders, prefer the benefit of a broad claim release to achieve global peace. Under these circumstances, the defendants and the D&O carriers will be unable to achieve global peace until the statute of limitations runs.

If the plaintiffs' bar files less class actions and more individual suits on behalf of institutional investors, who will protect the small investors and bring cases on their behalf? These investors would have significant obstacles pursuing remedies in Court for securities fraud. Therefore, such investors may look to the SEC for recovery. Since the SEC is not required to prove reliance in 10b-5 claims, any rejection of fraud on the market would not impact the Commission's ability to file enforcement actions. When the SEC settles enforcement actions, the Commission can establish fair funds to compensate investors. However, the size of such funds does not compare to the typical securities class settlement. This may lead to pressure on both the SEC to bring more enforcement actions and on Congress to provide the SEC with more power for purposes of achieving larger recoveries. We also note that SEC enforcement actions are less predictable than securities class actions.

Potential Impact on D&O Insurance Marketplace

While we cannot be certain how the Supreme Court will rule in *Halliburton* and how the plaintiffs' bar will respond, one thing remains clear: public companies and their directors and officers should not forego or otherwise limit their D&O insurance. In the immediate aftermath of *Halliburton*, we may see increased defense costs while plaintiffs' firms and the lower courts attempt to hash out the effects of the Supreme Court's decision. For example, as mentioned above, any substantial modification of *Basic* will likely lead to courts having to address misstatements being pled as omissions. Some have suggested that, if *Basic* is overturned, the ultimate impact would include less of a need for large D&O insurance towers and a reduction of rates. However, as stated above, the plaintiffs' securities class action bar has shown resilience and resourcefulness in the wake of previous securities law reforms, and we may see more decentralized litigation with numerous investor suits in multiple venues like we are seeing with regard to derivative lawsuits.

Recently the Supreme Court heard oral arguments in the *Halliburton* case. The Justices' questions during oral argument seem to suggest that the Court will not entirely reject *Basic*'s fraud-on-the-market presumption and may move toward a middle-ground approach based on a proposal from an amicus brief submitted on behalf of two law professors. The brief advocated requiring an event study during the class certification phase for purposes of demonstrating price impact—in other words, the study would have to show that the misrepresentation at issue actually distorted the market. Although this would create an additional hurdle for securities plaintiffs seeking to certify a class, this might be a desirable outcome of this case both conceptually and practically. Of course, we should point out the unintended consequence that, if the Court adopts this approach, those cases that do survive class certification might very well result in larger settlements and increased plaintiffs' attorney fee awards. In any event, whatever the outcome we have no doubt that there will continue to be a significant role for the D&O insurance marketplace. Indeed, all of us in the industry will continue to look for ways to adapt the coverage and terms to address the needs of our policyholders.

For more information about the status and potential implications of this case, please contact:

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