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InSights

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Halliburton: U.S. Supreme Court Declines to Overturn basic, Allows Defendants to Rebut Presumption of Reliance

On June 23, 2014, the U.S. Supreme Court released its long awaited decision in *Halliburton Co. v. Erica P. John Fund*, in which the Court had taken up the question of whether to set aside the presumption of reliance based on the fraud on the market theory that the Court first recognized in its 1988 decision in *Basic, Inc. v. Levinson*. The case was closely watched because its outcome had the potential to transform securities class action litigation in the United States.

While the Court's decision will not alter the securities litigation landscape, the Court's holding that defendants may, at the class certification stage, seek to rebut the presumption of reliance based on the absence of price impact could have an effect on securities litigation.

In the end, the Court, in an opinion written by Chief Justice John Roberts and joined by five other justices, declined to overturn *Basic,* but held that a securities class action defendant should have the opportunity at the class certification stage to try to rebut the presumption by showing that the alleged misrepresentation did not impact the defendant company's share price.

While the Court's decision will not alter the securities litigation landscape, the Court's holding that defendants may, at the class certification stage, seek to rebut the presumption of reliance based on the absence of price impact could have an effect on securities litigation. Defendants were already allowed to introduce this kind of evidence at the merits stage and at the class certification stage in order to counter a plaintiff's showing of market efficiency, but they were not allowed to rely on that same evidence to rebut the presumption of reliance, a restriction the high Court said "makes no sense." In any event, the class certification phase will likely become more costly as the parties dispute the issues surrounding the impact of the alleged misrepresentation on the share price.

Background

The Halliburton case has been pending since 2002. In their complaint, the plaintiffs allege that the company and certain of its directors and officers understated the company's exposure to asbestos liability and overestimated the benefits of the company's merger with Dresser Industries. The plaintiffs also allege that the defendants overstated the company's ability to realize the full revenue benefit of certain cost-plus contracts.

Since the U.S. Supreme Court's 1988 decision in *Basic, Inc. v. Levinson*, securities plaintiffs seeking class certification have been able to dispense with the need to show that each of the individual class members relied on the alleged misrepresentation, based on the presumption that in an efficient marketplace, a company's share price reflects all publicly available information about a company, including the alleged misrepresentation,

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and that the plaintiff class members relied on the market price.

In the U.S. Supreme Court's 2013 decision in *Amgen,* at least four justices (Alito, Scalia, Thomas and Kennedy) appeared to question the continuing validity of the presumption. In his concurring opinion, Justice Alito asserted that the presumption "may rest on a faulty economic premise," and specifically stated that "reconsideration" of the *Basic* presumption "may be appropriate."

Since the Court did not overturn Basic, we do not expect the decision to have a dramatic impact on class action securities litigation.

Recognizing the opportunity to have the Court reconsider the fraud on the market theory, the defendants in the long-running *Halliburton* securities class action litigation sought to have the Court consider whether it should "overturn or significantly modify" the Basic presumption of "class wide reliance derived from the fraud on the market theory." The fraud on the market theory has served as the bedrock of securities class actions for over the past quarter century.

Discussion

Since the Court did not overturn *Basic,* we do not expect the decision to have a dramatic impact on class action securities litigation. Nevertheless, the Court's ruling will have an impact on class certification in misrepresentation cases brought pursuant to Rule 10b-5. It will introduce a significant level of inquiry and dispute at the class certification stage, and it will result in some denials of class certification motions in cases in which class certification might have been granted in the past.

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There will be disputes about the quantum of evidence the defendants must provide in order to rebut the presumption. Further, there will be issues surrounding the type and scope of discovery permitted as the parties wage a battle of experts on the price impact issue. The lower courts could be wrestling with these issues for years.

Because the price impact dispute will require the parties to present expert analyses on the question of whether or not the alleged misrepresentation affected the share price, the dispute could prove costly, particularly as the parties and the courts sort out the issues noted in the preceding paragraph. These processes could significantly increase defense expenses at an earlier stage of the proceedings.

Justice Ginsburg, in a concurring opinion in which Justices Breyer and Sotomayor joined, noted that because the Court recognized that "it is incumbent upon the defendant to show the absence of price impact," the Court's holding "should impose no heavy toll on securities fraud plaintiffs with tenable claims." Her opinion makes no comment with respect to the additional costs defendants will undoubtedly incur at the class certification stage in an effort to try to rebut the presumption.

Another consequence of the Court's opinion is that it may affect the way that plaintiffs plead their cases. The *Basic* presumption only applies to misrepresentation cases under Rule 10b-5 of the Securities Exchange Act ('34 Act). It does not apply to cases in which the allegedly misleading statement is an omission. In omission cases, the plaintiffs rely on a different presumption, the *Affiliated* Ute presumption, which arguably is unaffected by the Court's holding in this case. In addition, the *Basic* presumption does not apply to cases in which the plaintiffs allege violations of Sections 11 and 12 of the Securities Act ('33 Act). In order to try to avoid the procedural hurdles that the Court's opinion in Halliburton introduces, plaintiffs may seek to cast their cases as omission cases or may prefer to pursue '33 Act claims rather than claims under the '34 Act and Rule 10b-5.

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From an insurance perspective, the Court's holding in this case will not have the disruptive impact that it might have had if the Court had overturned *Basic.* The Court's ruling that defendants may seek to rebut the presumption of reliance by showing the absence of price impact may result in fewer cases being certified, which would be beneficial for defendants and their insurers. However, the dispute of price impact issues could increase overall defense expenses, perhaps significantly, which could have its own impact on D&O insurers. Whether the ruling will result in fewer cases being filed remains to be seen.

In the end, the insurance marketplace will have to wait and see how these issues play out, and in the interim it seems unlikely there will be any immediate changes in the way D&O insurance is underwritten and priced. There will, however, be some discussion in the marketplace about the extent of coverage available for the kind of price impact event studies that the Halliburton court discussed. In anticipation of the Halliburton ruling, at least one carrier has already introduced an endorsement providing that no retention is applicable to the cost of an event study. There may be other marketplace developments along these lines as the marketplace responds to the Court's ruling.

However, the dispute of price impact issues could increase overall defense expenses, perhaps significantly, which could have its own impact on D&O insurers.

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