

## Game Changer? The U.S. Supreme Court to Revisit "Fraud on the Market" Presumption

### Introduction

In a development that has the potential to change the way private securities suits in the United States are litigated, the U.S. Supreme Court has agreed to take up a case in which the petitioners seek to have the Court revisit the "fraud on the market" presumption. The presumption allows plaintiffs in securities suits brought pursuant to Section 10(b) to seek certification of a shareholder class without having to show that each one of the shareholders relied on the alleged misrepresentation. Without the benefit of the presumption, it would be much more difficult for Section 10(b) claimants to pursue their claims as a class action.

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Because of the possibility that the Court could set aside the "fraud on the market" theory in the case, the long-running *Halliburton* securities suit could prove to be the most important securities case before the Court in a generation. If the presumption is set aside, the D&O claims landscape as we have known it would be significantly changed, with very significant implications for the securities litigation bar and for the D&O insurance industry.

### Background

Since the U.S. Supreme Court's 1988 decision in *Basic, Inc. v. Levinson* (*Basic*), 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, and that the plaintiff class members relied on the market price.

The "fraud on the market" presumption has many critics. In connection with the U.S. Supreme Court's 2013 decision in the *Amgen* case, 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." In his dissenting opinion in the case (in which Justices Scalia and Kennedy joined), Justice Thomas noted that the *Basic* decision itself is questionable.

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class action litigation filed a petition for a writ of certiorari expressly seeking 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.”

Halliburton filed its petition in connection with a securities class action lawsuit that has been pending against the company and certain of its directors and officers 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.

For several years now, the parties in the case have been engaged in full-scale combat on the issue of whether or not a class should be certified in the case. Indeed, the class certification issue in the case has already been before the U.S. Supreme Court; in 2011, the Court unanimously rejected the company’s argument (and the Fifth Circuit’s holding) that in order for a plaintiff to obtain class certification, the plaintiff must first establish loss causation. Following the Supreme Court’s ruling, the case was remanded back to the lower courts, and in June, the Fifth Circuit certified a class in the case.

The *Halliburton* case is now back before the Court. The Court will again review what issues may appropriately be considered at the class certification stage. In its petition, the company argued, among other things, that the *Basic* presumption is based on outdated economic theory and that the special considerations given putative class plaintiffs in securities suits are not in keeping with the Court’s more recent class action case law, particularly the Wal-Mart and Comcast cases.

### *Discussion*

The possibility that the Court could set aside the fraud on the market presumption means that the *Halliburton* case could be, in the words of leading securities plaintiffs’ attorney Max Berger of the Bernstein Litowitz firm (as quoted in Alison

*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 filed a petition for a writ of certiorari expressly seeking 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.”*

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Frankel's November 15, 2013 *On the Case* blog) a "game changer." As Jordan Eth and Mark R.S. Foster of the Morrison Foerster law firm noted in their November 15, 2015 memo about the Supreme Court's cert grant in the case, Halliburton "has the potential to be the most significant securities case in a generation." As Frankel noted in her blog post, without the benefit of the presumption of reliance at the class certification stage, "it is hard to imagine how plaintiffs' lawyers will be able to win certification of securities fraud class actions."

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But while the Halliburton case has the potential to change the way private securities lawsuits are litigated in the United States, the outcome of the case is far from certain. There are a range of possible outcomes in the Supreme Court's consideration of the case.

First, though it only requires four votes for the Court to take up a case, it takes five votes to determine the outcome of a case. The obvious candidate to supply the fifth vote in Halliburton is Chief Justice John Roberts, who generally votes with the four justices in the Court's conservative wing. However, in the Court's recent Amgen decision, Roberts did not vote with the dissenting and concurring conservatives; instead, he joined Justice Ginsberg's majority opinion, where she specifically noted that Congress had amended the securities laws in 1995 without altering the *Basic* presumption. In other words, just because the Court granted the cert petition, it doesn't necessarily mean that the *Basic* presumption will be set aside.

Second, although the petitioners expressly sought to have the Court consider whether to "overturn or significantly modify" the *Basic* presumption, that was only one of two issues the petitioners sought to have the Court address. The petitioners also sought to have the Court consider "Whether, in a case where the plaintiff invokes the presumption of reliance to seek 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 order granting the cert petition, the Court did restrict its consideration of the case to either of the two issues, which suggests that the Court will consider both issues. The existence of the second issue raises the possibility that, rather than setting aside a precedent of 25 years' standing, the Court might instead explain the ways in which (and when) the *Basic* presumption may be rebutted, if at all, at the class certification stage. While this outcome would unquestionably represent a significant securities litigation development, it would not be as revolutionary.

In his November 17, 2013 post on his *D&O Discourse* blog, Doug Greene of the Lane Powell law firm outlines a range of other additional ways the Supreme Court might rule short of simply throwing out the fraud on the market theory. Even if the Supreme Court sets the fraud on the market presumption aside, private securities litigation will go on. As Doug Greene observes in his blog post, "the plaintiffs' securities bar would adjust."

Among other things, it is important to note that the *Basic* presumption applies to misrepresentation cases under Section 10(b) of the Exchange Act. As Stanford Law Professor Joseph Grundfest is quoted as saying in Alison Frankel's blog post, even if the court eliminates the *Basis* presumption, "investors in some cases will still be able to bring class actions under Section 11 of the Securities Act of 1933," which does not require a showing of reliance, but holds defendants strictly liable for material misrepresentations.

In addition, the requirement to show reliance is arguably limited to misrepresentation cases. As one commentator in Frankel's blog post notes, there is precedent holding that in cases alleging omissions rather than misrepresentations, the shareholder claimants do not have to show that they relied on the omissions. In other words, even if the Court were to set aside the *Basic* presumption, the plaintiffs' attorneys could try to work their way around the problem by recasting their allegations as omissions rather than misrepresentations.

It is also worth noting that securities cases are already being litigated in varying ways. Many of the securities suits filed in the wake of the financial crisis were filed as individual actions or group actions, not as class actions. And while that was due in part to the fact that many of the claimants in the credit crisis cases were able to plead massive individual damages, the fact is that the leading plaintiffs' firms already have extensive experience litigating securities cases other than on a class basis. In addition, the plaintiffs' firms have established significant client relationships with pension funds and other large institutional investors whose claims could be aggregated to present a collective action on behalf of a group of investors, even if those claimants might not be able to proceed as a class action.

As Doug Greene notes in his blog post, the non-class securities lawsuits "would be no less expensive to defend than today's class actions" -- and could even be more expensive as they could require more complex case management. Greene

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also notes that experience with opt-out litigation shows that individual actions have tended to settle for a larger percentage of damages than today's securities class actions. And even those cases that do settle won't preclude additional suits by other investors, raising the possibility of opportunistic follow-on suits.

And even if the Court were to set aside the *Basic* presumption, there is the question of what would happen next. Would the SEC be under pressure to bring more enforcement cases? Would Congress be under political pressure to provide an alternative means for aggrieved shareholders to obtain a recovery, particularly small investors who might be shut out of class action cases?

All of that said, there is no doubt that if the *Basic* presumption were set aside, it would change the way that securities lawsuits are litigated in this country. In Section 10(b) misrepresentation cases, it would become much more difficult for plaintiffs to obtain class certification. Without the benefit of being able to hold out the threat of ruinously large class-wide damages, plaintiffs' lawyers would be less able to extract the kind of massive settlements that have become a feature of private securities litigation.

Without the possibility of being able to leverage outsized settlements, plaintiffs' lawyers would likely file fewer cases. In insurance industry terms, the elimination of the fraud on the market presumption could mean material reduction in claim severity.

It seems likely that among the many consequences that would result if the *Basic* presumption were set aside, the way many public companies purchase D&O insurance would also change. As Joe Monteleone noted on his *D&O E&O Monitor* blog, the end result could be that "there will be less of a need to buy large towers of D&O insurance, a likely reduction in rates and perhaps an overall shrinking of the D&O marketplace with fewer players and less revenue to both the insurer and brokerage communities." Of course, if securities litigation were to mutate into something smaller but more complex, the impact on D&O purchasing patterns and rates could take a different turn.

In other words, though there are a lot of possible outcomes, the *Halliburton* case has enormous potential significance for the D&O insurance industry. And although the Supreme Court has not yet set a briefing schedule, the case will likely be heard and decided before the end of the current term, in June 2014.

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### About the Author

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