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Litigation Alert

A Possible "Midway Position" on the Fraud-on-the-Market Theory in Securities Class Actions?

Questioning at oral argument on Wednesday in *Halliburton Co. v. Erica P. John Fund, Inc.* suggested that the Court may adopt a "midway position" on the continued validity of the presumption of class wide reliance established by the fraud-on-the-market theory created by *Basic v. Levinson.* The Court's decision has the potential to be one of the most important securities law decisions in decades since it could reshape the requirements to obtain class certification in Section 10(b) class actions.

The Supreme Court heard oral argument on Wednesday in *Halliburton Co. v. Erica P. John Fund, Inc.* on whether one of the cornerstones of securities class actions brought under Section 10(b) of the Exchange Act—the presumption of class wide reliance established by the fraud-on-the-market theory created by *Basic v. Levinson*—remains valid today. While four justices appear to support the presumption and four oppose, the questioning at oral argument suggested that the Court may also adopt a "midway position" which would, in effect, keep the presumption, but increase the level of proof required to invoke it at class certification. The Court's decision has the potential to be one of the most important securities law decisions in decades since it could reshape the requirements to obtain class certification in Section 10(b) class actions.

The Fraud-on-the-Market Presumption

The fraud-on-the-market presumption was first endorsed by the Supreme Court in *Basic v. Levinson* over 25 years ago. The premise of the presumption is that the price of a security traded in an efficient market will reflect all publicly available information, and therefore a buyer of that security will be presumed to have relied upon that information in buying the security. The presumption plays a pivotal role in securities class actions, as it allows class wide proof of the Section 10(b) element of reliance. Indeed, without the presumption, proof of reliance could

require an individualized inquiry into the information that each investor relied on and make class certification more difficult, if not impossible.

The Supreme Court considered the fraud-on-the-market presumption last year in *Amgen Inc. v. Connecticut Retirement Plan & Trust Funds*. While noting that certain predicates of the fraud-on-the-market presumption, including market efficiency, public knowledge of the alleged misrepresentations and the timing of the relevant transactions, are required to be proved to invoke the presumption at class certification, the court in *Amgen* held that another predicate—materiality—is not required to be shown to achieve class certification.

While *Amgen* was not a direct challenge to the fraud-on-the-market presumption, it did foreshadow that such a challenge would be considered. Justices Scalia, Thomas, Kennedy and Alito all indicated that they may overrule the presumption, calling it "regrettable" and "questionable," and noting that it may be "appropriate" to reconsider it. Defendants in *Halliburton* answered the call of the four justices in *Amgen* and the Court granted their petition for a writ of certiorari to directly challenge the validity of the fraud-on-the-market presumption.

A Possible "Midway Position"

The Supreme Court heard oral argument in *Halliburton* on March 5, 2014. While the Court's decision in *Amgen* hinted at the direction of possible votes, with the more liberal wing of the court likely voting to uphold the fraud-on-the-market presumption and the more conservative wing likely voting to overrule it—with Chief Justice Roberts being a possible tie-breaker— the Justices' questioning at oral argument suggested that the Court is also considering a third, "midway position" approach. Indeed, much of oral argument focused not on whether the presumption is valid or should be overruled, but on when and how the presumption may be invoked.

Justice Kennedy—who has previously expressed hostility towards the presumption—led the questioning regarding an amicus brief filed by Professors Adam Pritchard of the University of Michigan and M. Todd Henderson of the University of Chicago which argued that plaintiffs should be required to show at class certification, using event studies, that the alleged fraud affected market price. Such an approach would place price impact in the category of proof which must be shown at class certification, as opposed to at the merits stage. Chief Justice Roberts appears to favor this approach as well, while some of the more liberal justices, including Justices Kagan, Sotomayor and Breyer, appeared skeptical.

A Net-Win for Defendants?

While it's hard to predict what the result will be, the "midway position" requiring plaintiffs to show price impact at class certification is a real possibility. This would be a net-win for corporate defendants since it would increase the costs and efforts of obtaining class certification, but would be a far cry from the overruling of *Basic v. Levinson* that many hope for. Interestingly, counsel for the Justice Department, which argued in favor of maintaining the presumption, also

appeared to support the "midway position," saying it would be a "net gain to plaintiffs" since they already have to prove price impact on the merits.

The questioning at oral argument suggests that some Justices are grappling with a bigger issue related to the costs and ramifications of class certification. Most cases settle soon after class certification, regardless of the strength of the case. Once a class is certified, only about seven percent of cases make it to summary judgment and only a small fraction of a percent make it to trial. Members of the Court appear to be struggling with the issue of meritless cases surviving class certification and defendants being forced into settlements due to the leverage plaintiff gains with the threat of expensive discovery. Congress attempted to address this with the adoption of the Private Securities Litigation Reform Act in 1995, which sought to curb perceived abuses in securities litigations by reforming class action procedures, though the results have been mixed. This appears to be an issue ripe for further legislation.

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