KAYE | SCHOLER

June 24, 2014

Litigation Alert

Supreme Court Adopts a "Midway Position" on the Fraud-on-the-Market Theory in Securities Class Actions

On June 23, 2014, the US Supreme Court determined the continuing vitality of the fraud-on-the-market theory in securities class actions. As predicted in our March 7, 2014 Litigation Alert, the Court adopted a "midway position" in *Halliburton Co. v. Erica P. John Fund, Inc.* by keeping the presumption alive, but providing a defendant with the opportunity to rebut the presumption at the class-certification stage. While the decision may not fundamentally change securities class actions, it does provide defendants with the ability to end a class action at the class-certification stage (prior to discovery) where an event study establishes that there is no price impact as a result of the alleged fraud.

The Fraud-on-the-Market Presumption

The fraud-on-the-market presumption was first endorsed by the Supreme Court in *Basic v. Levinson* more than 25 years ago. The premise of the presumption is the "efficient capital markets hypothesis"—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 classwide 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.

A "Midway Position"

Despite the heavy criticism the fraud-on-the-market presumption has received in recent years, the Supreme Court declined to overrule it in *Halliburton*, holding that developments since *Basic* do not constitute the "special justification" needed to depart from established precedent. The Court devoted much of its opinion to rejecting Halliburton's argument that the presumption is no longer supported by economic theory. The Court acknowledged that the efficient-capital-markets hypothesis does not apply to all securities, but noted that the basic idea behind the hypothesis—that public information generally affects stock prices—remains true, even if there are exceptions. Next, the Court rejected Halliburton's argument that many investors do not, in fact, rely upon price integrity, noting again that while there may be exceptions, many investors do. In sum, while the Court appeared to recognize that the efficient-capital-markets hypothesis has some flaws, it concluded that there has not been a "fundamental shift in economic theory that could justify overruling a precedent on the ground that it misunderstood, or has since been overtaken by, economic realities." While the decision is seemingly unanimous, three Justices concurred in judgment only and voted to overrule *Basic in toto*, arguing that the economic theories behind the presumption are "highly contestable" and "simply wrong."

The Court next rejected Halliburton's argument that if the presumption survives, plaintiffs should be required to prove that a defendant's misrepresentation actually affected the stock price—i.e., had a "price impact"—in order to invoke the presumption at class certification. The Court held that, because a basic part of the presumption is that a misrepresentation affected the stock price, requiring the plaintiff to prove price impact would effectively jettison a large portion of the presumption itself.

However, the Court did modify the presumption in a way that benefits defendants. Under *Basic*, a defendant was afforded the opportunity to rebut the fraud-on-the-market presumption only at the merits stage and not at class certification. Since most cases settle after certification, in reality many defendants never get that opportunity. In *Halliburton*, the Court held that a defendant may rebut the presumption at class certification by showing there was, in fact, no price impact. The Court reasoned that since price impact evidence is already used to show market efficiency, which is required at class certification, it should also be allowed to rebut the presumption. While not specifically mentioned in the opinion, it is likely that concerns regarding the costs of discovery and implications of class certification impacted its decision.

Conclusion

By allowing defendants to defeat class certification in securities class actions by demonstrating a lack of price impact, *Halliburton* has created a new tool for defendants in fighting class certification. Defendants can use event studies to establish that a misrepresentation had no effect on defendant's stock price to defeat class certification and put an end to a baseless case without costly discovery.

Contact Us

Vincent A. Sama
+1 212 836 8765
vincent.sama@kayescholer.com

Catherine B. Schumacher
+ 1 212 836 8760
catherine.schumacher@kayescholer.com

Daphne Morduchowitz
+1 212 836 8708
daphne.morduchowitz@kayescholer.com

Joseph F. Clark
+1 212 836 7380
joseph.clark@kayescholer.com

Attorney advertising. Prior results do not guarantee a similar future outcome. The comments included in this publication do not constitute a legal opinion by Kaye Scholer or any member of the firm. Please seek professional advice in connection with individual matters. ©2014 by Kaye Scholer LLP, 425 Park Avenue, New York, NY 10022-3598.