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ADVISORY

June 2011

The Supreme Court Rejects Fifth Circuit's Loss Causation Test as a Prerequisite to Obtaining Class Certification in Section 10(b) Cases

On June 6, 2011, in *Erica P. John Fund, Inc.* v. *Halliburton Co.*,[1] the Supreme Court unanimously held that plaintiffs do not need to prove loss causation at the class certification stage of a securities fraud litigation. In a short opinion by Chief Justice Roberts, the Supreme Court rejected the requirement found by the United States Court of Appeals for the Fifth Circuit that in order to show "predominance" for a Rule 23(b)(3) class action, plaintiffs must establish loss causation. The Fifth Circuit first articulated this requirement in *Oscar Private Equity Investments* v. *Allegiance Telecom, Inc.*,[2] and then expanded and reiterated it in *Archdiocese of Milwaukee Supporting Fund, Inc.* v. *Halliburton Co.*,[3] which was the case on appeal before the Supreme Court.

The impact of the Court's holding should not be overstated. A majority of the federal courts that have addressed the issue had rejected the Fifth Circuit's approach to class certification.[4] Still, the decision is important because it clarifies several key aspects of securities fraud litigation, including when loss causation must be shown and how the "fraud-on-the-market" presumption is to be applied. Additionally, because many securities fraud lawsuits are resolved by settlement, achieving class certification is an important milestone as the cost of settlement for defendants generally rises significantly if class certification is granted. Had the Supreme Court adopted the Fifth Circuit's more restrictive approach to class certification, the impact on resolution of securities fraud claims may have been significant. Notwithstanding, while the Supreme Court rejected the requirement that loss causation must be shown as a prerequisite to class certification, it did so in a narrow fashion and left open arguments that class certification can nonetheless be defeated on not dissimilar grounds.

1 No. 09-1403 (June 6, 2011).

2 487 F.3d 261, 265 (5th Cir. 2007).

3 597 F.3d 330, 335 (5th Cir. 2010).

4 *See*, e.g., *Schleicher* v. *Wendt*, 618 F.3d 679 (7th Cir. 2010); *In re Salomon Analyst Metromedia Litig. (Salomon)*, 544 F.3d 474 (2d Cir. 2008).

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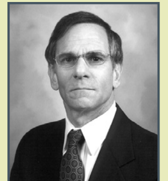

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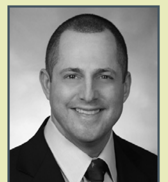

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Background: Fraud-On-The-Market Theory and Loss Causation in Securities Fraud Class Actions

The *Erica P. John* decision involves two important concepts in securities fraud litigation. The first is the fraud-on-the-market presumption. To prevail on a private securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, plaintiffs must prove, among other things, that they relied upon the defendants' misrepresentations. In *Basic* v. *Levinson*,[5] the Supreme Court held that because an efficient market incorporates all available public information about a stock, including any alleged misstatements, and passes that information to the investor through the price of the stock, an investor may establish its reliance on an alleged misstatement through a rebuttable presumption. This can have particular significance at the class certification stage when a plaintiff must demonstrate, among other things, "predominance" of common issues of law and fact, meaning that "questions of law or fact common to class members predominate over any questions affecting only individual members." It may be difficult for a class of investors to prove actual reliance on a particular misrepresentation, since investors rely on all sorts of different information and factors in deciding to transact in the stock. This difficulty can be overcome if plaintiffs can establish that the fraud-on-the-market presumption applies.

The second concept is loss causation. As part of the Private Securities Law Reform Act of 1995, Congress requires that a plaintiff prove that the "act or omission of the defendant . . . caused the loss for which the plaintiff seeks to recover damages."[6] The Supreme Court has held that in order to prove loss causation, plaintiffs need to allege and prove that the loss in the value of a security was related to the alleged misstatements.[7] Plaintiffs can do so by demonstrating that a disclosure correcting the earlier misinformation resulted in a share price drop. But, plaintiffs must also show that this price drop was not caused by factors unrelated to the misstatements, such as economic conditions, new industry-wide factors, other negative information about the corporation at issue, or other events.

The Fifth Circuit grounded its requirement that plaintiffs demonstrate loss causation at the class certification stage in *Basic* v. *Levinson's* observation that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff" will rebut the presumption of reliance.[8] The Fifth Circuit reasoned that *Basic* allowed "each of the circuits room to develop its own fraud-on-the-market rules" and that in order to invoke the fraud-on-the-market presumption, a plaintiff would be required to prove "that the misstatement *actually moved* the market . . . to establish loss causation in order to trigger the fraud-on-the-market presumption."[9] That position has now been rejected by the Supreme Court.

Proceedings in Lower Courts

In their complaint, the plaintiffs below identified three general kinds of purported misstatements related by Halliburton: (1) exposure to asbestos liability and the reserves associated with that liability; (2) accounting of revenue associated with cost over-runs on fixed-price construction and engineering contracts; and (3) its benefit from a merger with Dresser Industries. Following Fifth Circuit precedent, the district court concluded that it could not certify the class because the plaintiff had failed to establish that the stock losses were related to any of Halliburton's misstatements.

The Fifth Circuit Court of Appeals agreed, explaining that a plaintiff must "prove that its loss resulted directly *because* of the correction to a prior misleading statement; otherwise there would be no inference raised that the original, allegedly false statement caused an inflation in the price to begin with."[10] In other words, the Fifth Circuit's position was that if plaintiffs cannot show that the price dropped because of the corrective information, they have failed to

5 485 U.S. 224 (1988).

6 15 U.S.C. § 78u-4(b)(4).

7 *Dura Pharmaceuticals, Inc.* v. *Broudo*, 544 U.S. 336 (2005).

8 *Oscar*, 487 F.3d at 265 (quoting Basic, 485 U.S. at 245).

9 *Id.* at 265; *Archdiocese of Milwaukee Supporting Fund*, 597 F.3d at 335.

10 597 F.3d at 336.

show that the original market price incorporated the alleged misstatements. Without proof that the market price reflected the misstatements at issue, the Fifth Circuit held that there can be no presumption of reliance.

The Court of Appeals held that the disclosures identified by the plaintiffs did not "correct" information regarding the first two misstatement categories. Regarding the third misstatement category, the Court of Appeals held that the corrective disclosure contained multiple pieces of negative information that plaintiffs' expert failed to isolate from the corrective statement at issue. It thus held that plaintiffs had failed to show loss causation such that the presumption of reliance was rebutted and class certification denied.[11]

The Supreme Court's Decision

The only issue before the Supreme Court was whether plaintiffs needed to show loss causation to trigger the fraud-on-the-market presumption of reliance, thereby satisfying the predominance standard of Federal Rule of Civil Procedure 23(b)(3). The parties agreed that the plaintiffs satisfied the other requirements for class certification set out in Federal Rule of Procedure 23(a).

In deciding this question, the Supreme Court hewed closely to the express language of its prior precedent. It rejected the connection drawn by the Fifth Circuit in *Oscar* and *Archdiocese of Milwaukee Supporting Fund* between loss causation and reliance: "[W]e have never before mentioned loss causation as a precondition for invoking *Basic's* rebuttable presumption of reliance. The term 'loss causation' does not even appear in our *Basic* opinion."[12] Rather, whether a plaintiff presumptively relies on the alleged misstatement at issue because the market price of the security incorporated the misleading information is a different question than whether the misstatement also caused economic loss—according to the Court, the first is a question of reliance (also referred to as transaction causation) whereas the latter is loss causation. For example, if the share price dropped either in full or in part due to other intervening causes, such as changed economic circumstances, instead of due to a disclosure correcting the previous misinformation, then "a plaintiff would not be able to prove loss causation to that extent. This is true even if the investor purchased the stock at a distorted price, and thereby presumptively relied on the misrepresentation reflected in that price."[13] The Supreme Court therefore concluded that the "fact that a subsequent loss may have been caused by factors other than the revelation of a misrepresentation has nothing to do with whether an investor relied on the misrepresentation in the first place, either directly or presumptively through the fraud-on-the-market theory."[14]

Implications of *Erica P. John Fund, Inc.*

As noted above, the impact of the decision should not be overstated—the Fifth Circuit precedent at issue had largely been rejected by other federal courts. Moreover, there is language in the decision indicating that the "loss causation" requirement remains robust. Notably, the decision does not impact a plaintiff's requirement to adequately plead loss causation in their complaint, nor to prove loss causation at trial. This suggests that challenges to the adequacy of allegations may still be made at the pleading stage and through *Daubert*[15] challenges to plaintiffs' experts.

Even at the class certification stage, however, the Supreme Court's decision still suggests that certain types of challenges may be permissible. Notably, the Supreme Court's decision does not impact the holding of the Second Circuit in *In re Salomon Analyst Metromedia Litigation*, that although plaintiffs are not required to show loss causation to invoke the presumption of reliance, the defendants may nonetheless "rebut the presumption, prior to class certification, by showing . . . the absence of a price impact."[16] In fact, the Supreme Court cited the *Salomon Analyst Metromedia* decision with apparent approval, noting that it did not "requir[e] investors to prove loss causation at [the] class certifications stage."[17]

11 *Id.* at 341-43.

12 *Op.* at 6.

13 *Op.* at 7.

14 *Op.* at 7-8.

15 *Daubert* v. *Merrell Dow Pharmaceuticals,* 509 U.S. 579 (1993).

16 544 F.3d at 484.

17 *Op.* at 3.

The Court's decision leaves room for defendants to defeat class certification by demonstrating that the price was not affected by the alleged misstatements in order to overcome the fraud-on-the-market theory. The difference, however, is that the Court has now made clear that at the class certification stage the burden is on defendants to rebut the presumption of reliance by showing no price impact rather than on the plaintiffs to affirmatively show price impact in order to invoke the presumption of reliance.

If you have any questions about any of the topics discussed in this Advisory, please contact your Arnold & Porter attorney or any of the following attorneys:

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