U.S. Supreme Court Upholds Fraud on the Market Securities Class Actions and Largely Preserves the Status Quo

The United States Supreme Court today resisted the opportunity to put meaningful curbs on proliferating securities class actions, preserving most of the status quo in such cases.

The Court's much anticipated decision in *Halliburton Co. v. Erica P. John Fund, Inc.* addressed the continued vitality of the "fraud on the market" theory and the conditions that trigger its application. The "fraud on the market" theory, originally adopted by the Supreme Court in 1988 in *Basic v. Levinson,* 495 U.S. 224 (1988), permits a plaintiff – and investor classes -- to substitute *actual* reliance on a false or misleading statement with a *presumption* of reliance on the "integrity of the market." In other words, individual plaintiffs and other purchasers or sellers can certify classes and establish liability without proof that any investor saw, heard, read or even was aware of a fraudulent representation. Under the holding of *Basic,* the presumption of reliance is available to plaintiffs and classes who establish that the market for the subject security is "efficient." Proof of "efficient markets" has been based on such factors as the volume of trading, the number of market makers, analysts, arbitrageurs and institutional investors, eligibility for "short-form" securities filing and the like. Over the years, the twin holdings in *Basic* – adopting the "fraud on the market" presumption of reliance predicated upon "market efficiencies" – coupled with the ease of proving "efficiency," has been to promote virtually automatic certification of investor classes. The enormous exposure certified classes pose, in turn, have induced settlements of securities cases even where the liability risk seems remote.

The *Halliburton* case sought to challenge this regime, asking the Court to extinguish the "fraud on the market" theory altogether or reshape the conditions under which it could be invoked. Among other things, Halliburton argued that the economic theory of "market efficiency" upon which *Basic* was built had been widely discredited. Ironically, last fall two economists shared the Nobel Prize – one for having developed the theory of efficient markets, and another for having criticized it. Halliburton thus contended that the Supreme Court should not be in the business of choosing sides in an academic economics debate. The Court's decision accordingly had the chance to be a blockbuster; but as an opinion with momentous potential, the result instead was largely a bust.

In a 6-3 decision authored by Chief Justice Roberts, the Court explicitly refused Halliburton's invitations to eliminate "fraud on the market" or "market efficiency" as the trigger for its application. The Court rejected Halliburton's argument that the academic debate about "market efficiency" undermined *Basic's* reasoning, noting that those academic points largely echoed similar arguments voiced by the dissenting justices in *Basic* and did not undermine the "modest premise" that "public information generally affects stock prices." According to the Court, "Halliburton has not identified the kind of 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."

The Court also declined to alter a plaintiff's burden to secure certification of investor classes based on the "fraud on the market" theory. The Court specifically refused to adopt a proposal raised at oral argument that would have required plaintiffs to prove that the alleged fraudulent disclosure actually impacted the stock price in order to invoke the presumption. Relying on its reasoning for upholding *Basic*, the Court held that this approach would essentially nullify the first component of the *Basic* presumption which provides that, in efficient markets, stock price *is* affected by issuer news.

Although the Court rejected Halliburton's two principal arguments, it did permit defendants to oppose class certification with evidence that an allegedly false statement did not actually have a price impact on a company's stock. The Court held that defendants must be afforded the opportunity at the class certification stage to present evidence to rebut the presumption that the alleged misrepresentation had a "price impact" on the security. According to the Court, although *Basic* entitles plaintiffs to a presumption of a price impact, "it does not require courts to ignore a defendant's direct, more salient evidence" to the contrary. A defendant who can show that an allegedly false statement did *not* impact the market price of a security can use that evidence to oppose class certification. Although that argument could always have been made on the merits, the Court permitted it to be accelerated to the class certification stage.

That adds only a small additional weapon to defendants' already limited arsenal to oppose class certification. And its utility may be slight. The argument is likely to have most application to circumstances involving large cap issuers where the price impact of allegedly false or misleading statements is difficult to isolate. For large cap companies, what economists label "multiple confounding factors" sometimes preclude a reliable conclusion that a statement had a price impact. For small and mid-cap issuers, those "confounding factors" are less likely to be present.

Halliburton thus represents a missed opportunity to put greater curbs on securities class actions, and offers only a modest additional argument to defendants opposing class certification. Although Halliburton took a home run swing in trying to eliminate "fraud on the market" and its "market efficiency" trigger, the defense bar only hit a single. Plaintiffs will continue to hold a mostly winning hand at class certification in securities cases.