Will Halliburton Restore Parity To Securities Litigation?

Law360, New York (December 02, 2013, 4:04 PM ET) -- On March 5, 2014, the U.S. Supreme Court will hear arguments and determine by the end of June thereafter the case of Halliburton Co. v. Erica P. John Fund (for a second time). In the interim, the grant of certiorari set off a spate of impassioned commentary about the potential for the decision to effect a dramatic change in the conduct — perhaps even the ongoing viability — of class action securities litigation.

Given the significant economic impact of securities fraud class action litigation — with $2.9 billion in securities class action settlements in 2012 alone — a decrease in those cases would certainly be noteworthy. But, a major revision to the fraud-on-the-market presumption of reliance — a judicial creation rooted in a shaky hypothesis about the securities markets' ability to assimilate information and reflect it in a security's pricing — could also bring with it noticeable consequences to individual actions in the event that classwide securities litigation becomes less prevalent.

Basic and the Judicial Hypothesis Known as the Fraud-on-the-Market Theory

Created 25 years ago by a divided court in Basic Inc. v. Levinson, the fraud-on-the-market theory is premised upon the notion that an efficient capital market for securities incorporates all material information about a company into the company's stock price. When positive or negative information about a company is publicly disseminated (e.g., conveyed on an earnings call, in SEC filings or in a press release), this theory postulates that the market reacts — through hundreds or thousands of individual trades and analyst commentary — by adjusting the price of the company's stock accordingly.

Therefore, when allegedly materially false information is disseminated into the market, the hypothesis holds that the market price of a stock should become distorted. Rather than requiring a proposed class of purchasers and sellers of a security to demonstrate up front their express reliance upon a specific statement in making a decision to trade in the market, the Basic presumption is a construct which defers, sometimes indefinitely, that showing and instead permits those investors to demonstrate reliance indirectly for the purposes of class certification by purporting to rely on the integrity of the market price as a proxy for actual reliance.

In an effort to mitigate this significant expansion to potential liability under section 10 (b) of the Securities Exchange Act, Basic also holds that the presumption could be rebutted by any showing that severs the link between the misrepresentations and either the price received or paid by the plaintiff, or the decision to trade at the market price.

The Halliburton I and II Cases as Bookends to Amgen

Halliburton began its tour through the federal courts in 2002 when a purported class of

plaintiffs brought section 10(b) claims against the company for allegedly misrepresenting its potential liability in asbestos litigation, misreporting revenue on fixed-price construction contracts and overstating the potential benefits of a merger. Halliburton initially defeated class certification on loss causation grounds, but the Supreme Court in Halliburton I ultimately overturned that decision, holding that plaintiffs need not prove loss causation at the class certification stage to be entitled to a presumption of reliance.

On remand, Halliburton again opposed class certification on the grounds that the plaintiffs failed to show that any alleged misrepresentation actually affected (i.e., distorted) the market price and therefore the plaintiffs were not entitled to any presumption of reliance. The Court of Appeals for the Fifth Circuit held that while "price impact", or lack thereof, may be evidence of materiality, publicity and market efficiency — all of which are elements of the fraud-on-the-market presumption of reliance — it is also required to show loss causation, an essential element of any securities fraud claim. If the plaintiffs were unable to demonstrate that the price of Halliburton stock was affected by the alleged misrepresentations, then they would not be able to establish loss causation and all of the class's claims would fail. Because "price effect" evidence would apply equally to all claims in the class and could potentially resolve the action on a class-wide basis, the Fifth Circuit held that "price impact" was not appropriately considered at the class certification stage.

The Fifth Circuit relied heavily on Amgen Inc. v. Connecticut Retirement Plans and Trust Funds, decided by the Supreme Court after Halliburton I. That case held that a plaintiff need not prove materiality at the class certification stage to be entitled to a presumption of reliance because materiality doubled as an element of a securities fraud claim, and thus the failure to demonstrate materiality would not only cause individual issues to predominate, but further would dispose of all class claims on their merits. Of perhaps greater importance than the outcome in Amgen was the express indication that four justices were open to reconsidering the fraud-on-the-market theory itself.

Halliburton timely petitioned for certiorari on two grounds: (1) whether the court should overrule or substantially modify the holding of Basic to the extent that it recognizes a presumption of class-wide reliance derived from the fraud-on-the-market theory; and (2) 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. On Nov. 15, 2013, the petition was granted. Enter Halliburton II.

The Effect of a Decision Overturning or Significantly Limiting Basic's Presumption of Reliance May Reach Well Beyond Its Impact on Class Certification

Legal commentators agree that a decision overturning Basic's presumption of reliance will make certifying a securities fraud class difficult to nearly impossible. In the wake of a decision effectively reversing Basic, Professor Joseph Grundfest of Stanford Law School has been quoted as predicting a "scrum of individual actions" brought by large institutional investors under section 10(b), one that would bear many similarities to what is currently observed in opt-out litigation. Without the significant advantage of a classwide presumption, each plaintiff would be required to prove actual reliance on the alleged misrepresentation — a showing involving highly individualized determinations that would themselves predominate over class-wide issues. And, without the aggregating nature of the class format, investors with smaller losses arguably would lack any interest or would likely find it cost-ineffective to pursue a claim.

Eliminating the presumption of reliance will make certifying a class on securities fraud claims more difficult, but the implications may be broader: plaintiffs have long relied on the presumption of reliance on market price to establish the element of

reliance at the merits stage too. We believe many of those plaintiffs — especially institutional investors implementing sophisticated investment strategies — would be at a loss to demonstrate actual reliance on any particular public statements.

Here's why: trading strategies used by sophisticated investors — the type of investors that frequently are selected to serve as lead plaintiffs in class action securities litigation now as a result of the Private Securities Litigation Reform Act of 1995 — often depend on a range of financial metrics or other quantitative or qualitative factors, many of which are blatantly unrelated to public information released by an issuer and only tangentially related to a security's price qua price. One highly artificial benefit of Basic permits those plaintiffs to satisfy the reliance element at the class certification stage without any regard for whether the securities transactions at issue were based upon having actually seen, heard or even cared about the alleged misrepresentation or omission.

For those who practice in these trenches with regularity, it is not uncommon to depose lead plaintiffs that are entirely unable to testify to knowledge of — much less actual reliance on — the specific public statements that are alleged to be false. But, that ostensibly fatal flaw thus far has been covered up by the fraud-on-the-market presumption of reliance, as well as the class mechanism itself. Plaintiffs are often able to meet a less rigorously applied standard for establishing entitlement to the presumption of reliance at class certification, after which time the defendant's potential exposure often multiplies into an extraordinarily high number. For that reason, whether a plaintiff is truly entitled to the presumption of reliance — and, if not, whether the plaintiff can demonstrate actual reliance — is rarely significantly tested and the dispute often resolved prior to reaching the merits stage.

GAMCO Investors Inc. v. Vivendi SA — an opt-out case recently decided by Judge Shira Scheindlin of the Southern District of New York — provides an illustrative example of what may become more commonplace in the wake of a restructured presumption following Halliburton II. There, an asset management company with investments in Vivendi stock claimed that the company misrepresented its financial condition, specifically its liquidity risks, in several public statements. In deciding to purchase Vivendi stock, the plaintiff relied on an investment model called private market value ("PMV").

The PMV calculation was intended to determine the price an informed purchaser would pay for a company's assets in a private market transaction and was based on a number of financial metrics. On the plaintiff's summary judgment motion, Judge Scheindlin held that Vivendi raised material issues of fact regarding whether the plaintiff relied on the market price of Vivendi stock in its PMV model and was entitled to the presumption of reliance. The evidence presented demonstrated that the company's statements regarding its liquidity risks would have had a minor impact on the results of the PMV model, and thus would not have affected the plaintiff's trading decisions.

At a subsequent bench trial on the element of reliance, Judge Scheindlin held that the plaintiff was not so entitled to the presumption of reliance. She found that the plaintiff relied on market price only as a comparator to its PMV calculation. In other words, the plaintiff used market price only to determine whether a bargain opportunity existed. Further, the misrepresentations regarding liquidity did not affect the actual calculation of PMV. As further evidence that the market price was not the principal impetus for the plaintiff's decision to purchase Vivendi stock, the plaintiff actually purchased additional stock when the stock's price fell (increasing the difference between Vivendi's PMV and the market price) in the wake of Vivendi's disclosure of previously concealed information regarding its liquidity.

Even more importantly here, having lost the presumption of reliance, the plaintiff could not — and did not attempt to show — actual reliance, and judgment was entered in favor of Vivendi.

What Should We Expect in the Aftermath of Halliburton II?

At this point in time, and prior to seeing the merits briefs and hearing oral argument, it seems unlikely that the Fifth Circuit decision will be affirmed and Basic will survive totally unscathed from the court's review in Halliburton II.

If the court reaffirms Basic in theory but circumscribes the contours of its applicability, district courts will greatly benefit from any insight the court provides on improving the methodologies — at class certification or the merits stage — by which the presumption of reliance may be rebutted and the standards of evidentiary sufficiency for its application — especially regarding sophisticated investment strategies that reject or marginalize the role of market price in investment decisions.

For example, the court could specify — similar to Judge Scheindlin's opinion in Vivendi — that reliance on price must not be too attenuated. Losses incurred under many sophisticated trading strategies may be excluded from recovery if the court limits the extent to which an investor may be entitled to a presumption of reliance when using market price only as a comparator or essentially nonmaterial factor in an investment strategy that instead relies heavily on nonprice focused factors or other proprietary trading analytics.

Further, if the element of reliance were tested at the merits stage more frequently, we also can expect more securities fraud actions to reach a result similar to Vivendi. This would be a positive development, furthering the policy underpinnings of the federal securities laws, the application of which should result in outcomes that compensate for legitimately proven misconduct rather than provide a "judicially created investor insurance scheme."

For now, the class format creates an unacceptable imbalance in the economic risk of pursuing a case to its later stages of summary judgment or trial. If Halliburton II results in an outcome that significantly reduces the feasibility of class proceedings, we likely will see more plaintiffs put through their evidentiary paces on the element of reliance and a judiciary more amenable to rigorously exploring the evidence of same. Such a return to parity should find support from all constituencies seeking justice in the securities litigation arena.

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