Will the Fifth Circuit Get to Keep Its *Oscar?:* The Fraud-on-the-Market Presumption in Certification of a Securities Fraud Class Action

CASE AT A GLANCE

The Erica P. John Fund sued Halliburton Co. in a securities fraud class action for losses stemming from alleged misleading statements. Halliburton claimed that the Fund had not satisfied the predominance requirement for class certification. The Court must now determine a plaintiff's burden of proof to support class certification based on the so-called "fraud-on-the-market" presumption.

Erica P. John Fund, Inc. v. Halliburton Co.
Docket No. 09-1403

Argument Date: April 25, 2011
From: The Fifth Circuit

by Linda S. Mullenix
University of Texas School of Law, Austin, TX

ISSUE

The issue in *Fund* focuses on whether plaintiffs seeking certification of a securities fraud class action must, in addition to invoking a rebuttable fraud-on-the-market presumption, demonstrate by a preponderance of the evidence "loss causation"—that alleged misrepresentations had an impact on a company's stock price.

FACTS

The Erica P. John Fund, Inc. (the Fund), as lead plaintiff, brought a securities fraud class action on June 3, 2002, on behalf of its shareholders against Halliburton Co. and David J. Lesar, Halliburton's former president and CEO. The lawsuit was brought in the Northern District of Texas. In 2006, the plaintiffs filed a fourth amended complaint that alleged the defendants had violated the Securities Exchange Act of 1934 and Securities Exchange Commission Rule 10-b5.

The plaintiffs alleged that Halliburton committed securities violations by deliberately falsifying information and misleading the public in three ways: (1) falsely representing Halliburton's liability for asbestos claims; (2) engaging in accounting practices that obscured Halliburton's probability of collecting revenue on fixed price construction contracts; and (3) knowingly misrepresenting and touting the benefits of Halliburton's merger with Dresser Industries, which efficiencies Halliburton knew would not be realized.

The class period extended from June 3, 1999, through December 7, 2001. The plaintiffs essentially argued that during this interval certain corrective statements and disclosures made by Halliburton after its false and misleading statements caused the company's stock to decline, resulting in losses for its shareholders. After the complaint was filed, extensive discovery occurred and the Fund received more than 600,000 pages of documents from Halliburton.

In September 2007, the plaintiffs moved for class certification. The plaintiffs did not attempt to certify a class action where they would have to prove that every class member individually relied on Halliburton's disclosures or corrective statements. Rather, the plaintiffs invoked the "fraud-on-the market" presumption to satisfy the class certification requirement that common issues in the litigation—in this instance reliance on the false and misleading statements—predominated over individual issues.

The Fund filed an expert witness report known as an "event study" in support of the class certification motion to demonstrate that the market for Halliburton's stock was efficient—that is, the market price accounted for all available favorable and unfavorable information about the company. The purpose of establishing an efficient market during the class period was to support the plaintiffs' entitlement to rely on the fraud-on-the-market presumption. In response, Halliburton supplied its own expert report and documentary evidence showing that the stock price declines were caused by the release of unrelated negative news and other causes, not by "corrective" disclosures that revealed the falsity of prior statements. The Fund did not request any additional discovery in connection with the class certification process.

Relying on Fifth Circuit precedent in *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.,* 487 F.3d 261 (5th Cir. 2007), the district court denied class certification. The court held that plaintiffs who invoke the fraud-on-the-market presumption must show that the alleged false statements affected the stock's value. The court held that the plaintiffs failed to prove, by a preponderance of the evidence, that their losses were more probably caused by Halliburton's corrective statements than some other new information. This matter of proof in securities litigation has been labeled "loss causation." The court held that when a company makes mixed disclosures, plaintiffs have a heightened burden to separate actual corrective effects from the effects of new negative events.

Citing its own *Oscar* precedent, the Fifth Circuit affirmed the district court's denial of class certification. See 597 F.3d 330 (5th Cir. 2010). The Fifth Circuit first indicated that *Oscar* requires a court to assess an alleged misrepresentation's effect on market price at the class certification stage. In order to gain class certification, a plaintiff is required to prove loss causation—that is, "that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in losses." The court held that a plaintiff must do more than simply allege a misrepresentation and show a price decline following a subsequent disclosure of negative information; a plaintiff must show that a stock's price decline "resulted directly *because* of the correction to a prior misleading statement."

The court held that the Fund failed to show that any of Halliburton's alleged misrepresentations had distorted the market price on which investors relied. The court held, therefore, that the plaintiffs failed to establish loss causation as to Halliburton's statements regarding its asbestos liabilities, its accounting for revenue on unapproved claims, or its projections on the benefits of the merger with Dresser Industries. Consequently, the plaintiffs were not entitled to presume that the Fund and investors relied on the misrepresentations by relying on market price. Because there was no basis for assuming that investors relied on a distorted market price, the plaintiffs would have to prove reliance for each individual plaintiff, which defeated the predominance requirement for class certification.

CASE ANALYSIS

Shareholder securities fraud class actions are a specialized type of fraud litigation. When a plaintiff individually pursues an ordinary common law fraud claim, the plaintiff must prove that he or she knew of an alleged fraudulent or misleading statement and relied on that statement to his or her detriment. Pursuing fraud claims in the class action context, however, has been extremely difficult.

In order to certify a fraud class action for damages under Federal Rule of Civil Procedure 23(b)(3), plaintiffs must demonstrate that common issues of law or fact predominate over individual issues. Common law fraud claims entail inherently individual reliance issues. Therefore, almost all courts have refused to certify fraud class actions, believing that such classes simply cannot satisfy the predominance requirement.

In 1988, the Supreme Court announced a doctrine to enable class certification in securities fraud class actions by creating a rebuttable presumption that security purchasers rely on the integrity of the market price, which is presumed to incorporate all public, material misrepresentations. See *Basic Inc. v. Levinson,* 485 U.S. 224 (1988). This so-called *Basic* presumption, or the "fraud-on-the-market" presumption, enables a plaintiff in a securities fraud class action to submit proof of an efficient market of reliance in lieu of individual proof that would undermine the predominance requirement.

In order to invoke the fraud-on-the-market presumption of reliance, a plaintiff must establish that (1) the defendant made public, material misrepresentations, (2) the defendant's shares were traded in an efficient market, and (3) the plaintiff traded shares between the time the misrepresentations were made and the time the truth was revealed.

However, if a plaintiff satisfies these criteria, the Court in *Basic* also held that a defendant could then rebut the reliance presumption by showing that the misrepresentation in fact did not lead to a distortion in price. The *Basic* decision indicates that a defendant may rebut the presumption of reliance by refuting the elements of the presumption (such as market efficiency) or by making "[a]ny showing that severs the link between the alleged misrepresentation and either the price received or paid by the plaintiff, or his decision to trade at a fair market price."

If a defendant successfully rebuts the reliance presumption, then the causal connection between the misrepresentation and the plaintiff's reliance would be broken. When a defendant successfully rebuts the presumption, then the plaintiff must respond with sufficient evidence to reestablish the presumption. If the plaintiff cannot, then he or she would have to establish reliance on a plaintiff-by-plaintiff basis. Thus, if plaintiffs cannot demonstrate that they are entitled to a presumption of reliance on the market price, or otherwise show that common issues predominate over individual issues, then a court may not certify a class action under Rule 23.

Nearly two decades after the Supreme Court's articulation of the fraud-on-the-market presumption of reliance, the Fifth Circuit, in its 2007 *Oscar* decision, clarified standards for applying the presumption. Drawing on the Supreme Court's holding in *Basic* that a defendant is entitled to rebut the presumption, the Fifth Circuit indicated that courts may not apply the presumption where the evidentiary record at class certification shows that the alleged misstatements did not affect market price.

And, one year after *Oscar,* the Second Circuit similarly concluded that a court may not certify a securities class action using the fraud-on-the-market presumption if the evidence offered by the parties demonstrates that the alleged market misrepresentations did not affect market price. *In re Salomon Analyst Metromedia Litigation,* 544 F.3d 474 (2d Cir. 2008). In *Salomon,* the Second Circuit held that "[i]f defendants attempt to make a rebuttal … the district judge must receive enough evidence … to be satisfied that each Rule 23 requirement has been met."

In 2010, however, the Seventh Circuit strongly repudiated the Fifth and Second Circuits' approach, holding that a securities class action may be certified on the fraud-on-the-market presumption without considering whether alleged misrepresentations affected market price. *Schleicher v. Wendt,* 618 F.3d 679 (7th Cir. 2010). The Seventh Circuit indicated that the requirement that plaintiffs show that statements actually caused material changes in stock prices erroneously required that plaintiffs—in order to certify a class action—prove everything (except falsity) that would be required to win on the merits at trial. The Seventh Circuit held that price impact was a question related to the merits of the case, and therefore courts could not and should not consider this question at the class certification stage.

In addition to the Seventh Circuit's strong repudiation of the *Oscar* approach, several other federal district and circuit courts have disagreed with or distinguished the *Oscar* holdings. Consequently, there currently is a split among the federal courts concerning how the Supreme Court's *Basic* presumption applies at the class certification stage of proceedings.

The Fund contends that the Fifth Circuit's *Oscar* decision is wrong and is applied to defeat class certification of securities class actions. Consequently, the Court, according to the Fund, should reverse the lower courts' holdings, and repudiate *Oscar*. The Fund argues that the Fifth Circuit cannot unilaterally rewrite the Court's standards for entitlement to a presumption of reliance in securities fraud cases, and the Supreme Court did not intend, in its *Basic* decision, to authorize the lower federal courts to engraft new standards onto the simple requirements for invoking and applying the fraud-on-the-market presumption.

The Fund contends that loss causation is a separate and distinct element of a securities cause of action, and the *Basic* decision does not require that plaintiffs prove loss causation in order to use the fraud-on-the market presumption.

The Fund argues that the Fifth Circuit's *Oscar* approach, requiring a showing of loss causation at class certification, is an additional and substantial requirement that effectively nullifies the fraud-on-the-market presumption established by the *Basic* Court. The Fund argues that proof of loss causation is a merits issue that is appropriate for trial but is not appropriate or relevant for a court's determination whether a proposed securities class action is suitable for certification.

The Fund additionally argues that the Fifth Circuit's *Oscar* requirement of proof of loss causation also violates the Supreme Court's *Eisen* rule, which prohibits a court from evaluating class certification to rule on the underlying merits of the claims. See *Eisen v. Carlisle & Jacquelin,* 417 U.S. 156 (1974). In the *Fund*'s view, the Fifth Circuit's *Oscar* decision requires courts to prematurely evaluate the merits issue of loss causation. Thus, the Fund suggests that the issue before the Court is not whether a plaintiff must establish loss causation at trial but rather when the plaintiff must do so. The Fund contends that it is not proper to require plaintiffs to offer proof of loss causation at class certification, even when loss causation turns on common evidence.

Furthermore, the Fund argues that the Fifth Circuit's *Oscar* approach additionally prejudices plaintiffs by requiring proof of loss causation, at an early stage of proceedings, without sufficient merits discovery. The Fund contends that the *Oscar* decision imposes heightened class certification standards the Court did not authorize in *Basic,* imposes a higher standard at class certification than plaintiffs would have to satisfy at summary judgment, and violates the plaintiffs' Seventh Amendment right to trial by jury.

Halliburton, in response, urges the Court to uphold the Fifth Circuit's decision as an appropriate application of the *Oscar* requirements. The defendant essentially contends that a court may not certify a securities class action based on a fraud-on-the-market presumption where the evidence offered by the parties shows that no alleged misrepresentation affected the market price of a stock.

Halliburton's argument centers on its contention that the *Basic* decision supplies defendants with the opportunity to rebut the presumption of reliance, and that if the defendant does so successfully, then the burden shifts to the plaintiff to reestablish the causal link that entitles the plaintiffs to the presumption. If the plaintiff fails to do so, then the presumption fails and the plaintiff must show reliance on a plaintiff-by-plaintiff basis, which defeats the predominance element for class certification.

Halliburton argues that plaintiffs cannot simultaneously rely on a rebuttable presumption to obtain class certification, while denying defendants the ability to defeat class certification by rebutting the presumption.

Halliburton concedes that the question of whether a misrepresentation has an effect on a stock's market price may overlap with a merits question. Nonetheless, Halliburton contends that whether a misrepresentation distorted market price is directly relevant to a plaintiff's ability to show that common issues predominate. Consequently, a court must consider this issue in evaluating class certification.

Moreover, under the often-repeated "rigorous analysis" standard for class certification, it is sometimes necessary for courts to "probe beyond the pleadings" to evaluate whether the claims, defenses, and substantive law may be tried on a classwide basis. This type of inquiry, federal courts agree, does not violate the *Eisen* prohibition against considering some merits at class certification.

The defendant argues that there is no logical reason why a defendant should not be able to rebut the plaintiff's attempts to satisfy the Rule 23 requirements at class certification. Indeed, other prerequisites to class certification—such as the existence of an efficient market—may be rebutted at class certification. If the Supreme Court repudiates the *Oscar* requirement for proof of loss causation at class certification, the defendant claims that this would result in large numbers of securities class actions being certified and would postpone defendants' ability to rebut the presumption of reliance until much later in the proceedings. Such a ruling would be wasteful, inefficient, and impose *in terrorem* settlement pressure on defendants, even in meritless cases.

Halliburton suggests that a defendant's right to rebut a presumption of reliance should not be thwarted because of a plaintiff's purported need for discovery. Halliburton notes that if additional discovery is needed on loss causation, courts may order and manage such discovery. In addition, Halliburton points out that the Fund had five years and ample discovery production prior to class certification but did not ask the court for further discovery on the loss causation issue. Finally, Halliburton suggests that the *Oscar* decision does not frustrate a plaintiff's right to trial by jury but merely may eliminate a procedural means for pursuing remediation on a classwide basis.

On the facts, Halliburton argues that the Fund failed to meet its burden after Halliburton offered evidence showing that the misrepresentations did not affect the stock's market price, hence rebutting the presumption. Halliburton contends that the Fund's evidence fell far short of showing that a later stock price decline was attributable to corrective disclosures and not to general market declines or other information unrelated to the truth of the alleged misrepresentations.

SIGNIFICANCE

In the broadest sense, the *Fund* appeal is significant because the Court will determine whether to reimpose a very liberal set of standards for certification of securities class actions, upholding the *Basic* presumption of fraud-on-the-market without any other showing, or

will affirm lower court decisions which have, in effect, tightened and enhanced those *Basic* requirements. The fight embodies a dispute between the Fifth and Seventh Circuits concerning what plaintiffs have to demonstrate at the class certification stage to permit a court to allow a securities class action to proceed.

As such, the *Fund* decision has broad implications for stock market investors seeking recovery for investment fraud. The plaintiffs and their many amici have cast this appeal as a consumer protection case, asking the Court not to turn investors away from the courthouse at the class certification stage. The United States, as amicus, has joined the plaintiffs in asking for reversal of the Fifth Circuit's decision and the *Oscar* interpretation of the *Basic* holdings.

The Court will have to determine whether federal courts may require plaintiffs to prove loss causation at the class certification stage. The plaintiffs have suggested that this requirement embodies illegitimate "heightened pleading" at the class certification stage and imposes an improper assessment of the merits of the case—before trial. The plaintiffs further suggest that this is an unfair burden to impose on plaintiffs at an early stage of litigation, when the plaintiffs may have inadequate access to information needed to satisfy the additional requirement of proving loss causation to satisfy class certification requirements. The plaintiffs view this heightened class certification requirement as a means for courts to frustrate securities class actions at the very outset of the litigation.

The defendant, on the other hand, views the role of the court at class certification as evaluating whether it makes sense to proceed with a proposed class action that could not actually be tried based on common evidence and proof. If this is not true, then the defendants suggest that proposed class actions that cannot satisfy the Rule 23 requirements ought to be dismissed at the certification stage. The defendants cite to the large economic costs entailed in prosecuting class actions and the settlement pressure on defendants to settle cases if a court certifies a class—even in the instance of meritless claims.

In recent years, the Supreme Court has evinced a trend towards supporting heightened pleading requirements for ordinary and class action complaints. In addition, several lower federal courts, including the Second and Third Circuits, also recently have issued landmark decisions clarifying and strengthening the evidentiary burdens of production and persuasion at class certification. Court watchers will now focus on whether the Court in this appeal will endorse the *Oscar* standard, in light of these recent trends in pleading and class certification.

It is of some note that the Court has changed personnel since the *Basic* decision in 1988. Only four justices joined the Court's *Basic* opinion then: Justice Blackmun, Brennan, Marshall, and Stevens. Justices Rehnquist, Scalia, and Kennedy did not participate in the *Basic* decision, and Justices White and O'Connor dissented in relevant parts. Hence, the Court now has been almost completely reconstituted since the *Basic* decision, which first articulated the fraud-on-the-market presumption.

Moreover, in opinions by now-Justice Alito when he sat on the Third Circuit, that court similarly held on motions to dismiss that a plaintiff must establish a misrepresentation's price impact in order to invoke *Basic*'s fraud-on-the-market presumption. See *In re Burlington Coat Factory Sec. Litig.,* 114 F.3d 1410 (3d Cir. 1997); *Oran v. Stafford*, 226 F.3d 275 (3d Cir. 2000). It remains to be seen whether, in consideration of this *Fund* litigation, Justice Alito will import his views into the class certification context.

It seems reasonable to suggest, however, that if the Court upholds the Fifth Circuit's decision and allows the courts to keep the *Oscar* standard, then this will impose a greater burden on plaintiffs who wish to pursue class certification in securities fraud cases. On the other hand, if the Court reverts to a liberal interpretation of the *Basic* decision and presumption, then securities class litigation will continue to be robust in federal courts.

Linda S. Mullenix is the Morris & Rita Chair in Advocacy at the University of Texas School of Law. She is the author of *Leading Cases in Civil Procedure* (West 2010) and *Mass Tort Litigation* (West 2d ed. 2008). She can be reached at lmullenix@law.utexas.edu.

PREVIEW of United States Supreme Court Cases, pages 284–287.
© 2011 American Bar Association.

ATTORNEYS FOR THE PARTIES

For the Petitioner Erica P. Fund, Inc. (David Boies, 914.749.8200)

For the Respondent Halliburton Co. (David D. Sterling, 713.229.1234)

AMICUS BRIEFS

In Support of Petitioner Erica P. Fund, Inc.

16 Public Pension Funds (David C. Frederick, 202.326.7900)

Financial Economists (Ernest A. Young, 919.613.8506)

Law Professors Robert Bartlett et al. (Jill E. Fisch, 512.746.3454)

National Association of Shareholder and Consumer Attorneys (Michael J. Miarmi, 212.355.9500)

National Conference on Public Employee Retirement Systems (Robert D. Klausner, 954.916.1202)

Public Justice, P.C. (Arthur Bryant, 510.622.8150)

United States (Neal Kumar Katyal, Acting Solicitor General, 202.514.2217)

In Support of Affirmance

The American Insurance Association (Mark A. Perry, 202.887.3667)