
Supreme Court Rejects Proving Loss Causation as a Requirement for Class Certification in Securities Fraud Class Actions

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Overview

Last week, the Supreme Court handed a victory to securities class action plaintiffs for the second time this term¹ by rejecting the United States Court of Appeals for the Fifth Circuit's unique requirement that securities plaintiffs must demonstrate "loss causation"—*i.e.*, the causal link between an alleged securities fraud and plaintiffs' losses—as a predicate to class certification.

In *Erica P. John Fund, Inc. v. Halliburton Co.*, the Court unanimously held that showing loss causation—a required element for securities fraud liability—is not a component of establishing that a securities case may proceed as a class action.² After obtaining class certification, plaintiffs must still prove loss causation to prevail ultimately on the merits.³ But because the Fifth Circuit stood alone among the nation's circuit courts in requiring proof of loss causation before granting class certification,⁴ the overall impact of this decision is likely to be limited. Plaintiffs in securities fraud class actions will now have an easier time surviving the class certification stage in the Fifth Circuit, and in circuits that had not yet rejected the Fifth Circuit's loss

causation requirement, defendants will have one less defense to assert in opposing class certification.

Background of the Case

Lead plaintiff Erica P. John Fund, Inc. ("EPJ Fund") sued oilfield services company Halliburton Co. and one of its executives in the United States District Court for the Northern District of Texas for securities fraud based on alleged misstatements about the scope of Halliburton's potential liability in asbestos litigation, revenue from construction contracts, and the benefits of a merger.⁵ EPJ Fund claimed that the alleged misstatements were designed to inflate the company's stock price in violation of § 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder.⁶ The complaint alleged that the putative class of investors lost money when Halliburton's stock price dropped after a series of corrective disclosures.⁷

Because § 10(b) and Rule 10b-5 require proof that a plaintiff relied on the alleged misstatements, EPJ Fund asserted a "fraud-on-the-market" theory of reliance. The theory—which assumes that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations"⁸—allows a court to make a rebuttable presumption that each putative class member has satisfied the reliance element of the claim. In the absence of the presumption, no securities case would ever receive class action treatment under Rule 23(b)(3) of the Federal Rules of Civil Procedure because questions of each individual class member's reliance on the alleged misstatements or omissions would predominate.⁹ The Supreme Court's concern that putative class plaintiffs would be subject to this demanding evidentiary burden is the reason why it established the presumption in *Basic Inc. v. Levinson*.¹⁰ At the same time, in *Oscar Private Equity Investments v. Allegiance Telecom, Inc.*, the Fifth Circuit

recognized the "*in terrorem* power" of allowing plaintiffs to invoke such a presumption and acknowledged the *Basic* Court's limitation that the presumption could be rebutted by appropriate evidence.¹¹

After surviving Halliburton's motion to dismiss, EPJ Fund sought class certification under Rule 23 of the Federal Rules of Civil Procedure. Based on the Fifth Circuit's holding in *Oscar*, the District Court denied EPJ Fund's motion for class certification. Although the proposed class satisfied the certification prerequisites under Rule 23(a), the District Court concluded that Rule 23(b)(3)—namely, the predominance requirement—was not satisfied because EPJ Fund had not proven loss causation at the class certification stage.¹²

Specifically, the District Court conducted a required merits-based inquiry and concluded that EPJ Fund failed to prove loss causation by a preponderance of admissible evidence.¹³ Under the Fifth Circuit's holding in *Oscar*, EPJ Fund was required to prove loss causation to trigger the rebuttable presumption of reliance under a fraud-on-the-market theory.¹⁴ Among other things, the District Court concluded that EPJ Fund could not trigger the presumption "by simply offering evidence of a decrease in price following the release of negative information, without citing any actionable misrepresentation or disclosure by Halliburton."¹⁵

The Fifth Circuit affirmed the denial of class certification, noting that it too was bound by its holding in *Oscar*. According to the panel, EPJ Fund was required to, but did not, prove "that the corrected truth of the former falsehoods actually caused the stock price to fall and resulted in the losses."¹⁶ By way of example, with respect to the alleged misstatements regarding potential liability from asbestos litigation, the panel noted that, although EPJ Fund demonstrated that the stock price declined after various jury verdicts

were announced, it concluded that "a decline in price following negative news does not prove loss causation."¹⁷ For other alleged misstatements related to construction contracts, the panel concluded that EPJ Fund provided no link between the decline in stock price and a specific culpable misstatement, attempting instead to rely "only on evidence of a decrease in stock price following the negative disclosure of a fourth quarter charge."¹⁸

Supreme Court Rejects Need for Proof of Loss Causation for Class Certification

In *Halliburton*, the Supreme Court, in a unanimous opinion authored by Chief Justice Roberts, vacated the Fifth Circuit's decision and remanded for further proceedings.¹⁹ The Court addressed only the narrow issue of whether a putative class plaintiff must "prove the separate element of loss causation in order to establish that reliance was capable of resolution on a common, classwide basis."²⁰ Noting that the phrase "loss causation" does not even appear in *Basic*, the Court held that proving loss causation at the class certification stage was neither required nor justified.²¹ In requiring plaintiffs to prove loss causation at the class certification stage, the Fifth Circuit extended the holding in *Basic* by conflating the separate elements of reliance—sometimes referred to as "transaction causation"—and loss causation.²² The Court squarely rejected this approach: "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."²³

The Court also rejected Halliburton's argument that, despite repeated references to loss causation in the panel opinion, the Fifth Circuit actually required EPJ Fund to demonstrate only price impact, not loss causation.²⁴

Although the Fifth Circuit panel discussed the drop in stock price as part of its loss causation analysis, it clearly stated that binding Fifth Circuit precedent required EPJ Fund to prove loss causation to trigger the fraud-on-the-market presumption of reliance.²⁵ The Supreme Court, noting that price impact and loss causation are distinct concepts, took the Fifth Circuit at its word.²⁶

In limiting its decision to the narrow issue of loss causation, however, the Court left unresolved an issue of perhaps broader application—whether a putative class plaintiff must prove price impact as a threshold matter in order to trigger *Basic*'s rebuttable presumption of reliance. Although *Basic* makes clear that the presumption may be defeated by demonstrating that the alleged fraud had no impact on the stock price, it does not impose an affirmative requirement on the plaintiff to demonstrate price impact to obtain class certification.²⁷ The *Halliburton* opinion declined to address whether the Fifth Circuit's imposition of that burden on the plaintiff at the class certification stage was proper.²⁸

***Halliburton* Does Not Undo Requirement that Securities Plaintiffs Must Prove Loss Causation to Prevail**

Although this pro-plaintiff decision clarifies that proving loss causation is not a prerequisite to class certification, it is not likely to have a significant impact outside of the Fifth Circuit. In circuits that had not yet rejected *Oscar*, defendants will now have one fewer argument to make when opposing class certification. Given that the tide of lower court opinions in those circuits had already been moving against the application of the *Oscar* rule,²⁹ the *Halliburton* decision is unlikely to alter the class certification landscape in those places in a manner that substantially affects litigation or settlement outcomes. Importantly, the Court's decision does not disturb or

undermine in any way the other elements putative class plaintiffs must establish in order to obtain class certification.³⁰ Securities class action plaintiffs must still prove loss causation to prevail on the merits of their securities fraud claims—a substantial obstacle that a number of securities class actions fail to survive.³¹

Further, reliance remains an "essential element of the § 10(b) private cause of action."³² The Court's decision does not alter what all circuits already required prospective class plaintiffs to show in order to invoke the rebuttable presumption of reliance addressed in *Basic*: "that plaintiffs must demonstrate that the alleged misrepresentations were publicly known (else how would the market take them into account?), that the stock traded in an efficient market, and that the relevant transaction took place between the time the misrepresentations were made and the time the truth was revealed."³³

¹ In March 2011, the Supreme Court unanimously rejected the use of a bright-line test of "statistical significance" for determining whether an investor-plaintiff in a securities fraud action has adequately pled the materiality of a misstatement or omission. See *Matrixx Initiatives, Inc. v. Siracusano*, No. 09-1156, 563 U.S. ---, Slip Op. at 11 (Mar. 22, 2011); WilmerHale Client Alert, *Supreme Court Rejects "Bright-Line" Materiality Rule in Securities Cases*, (Mar. 29, 2011), available at www.wilmerhale.com/publications/whPubsDetail.aspx?publication=9748.

² *Erica P. John Fund, Inc. v. Halliburton Co.*, No. 09-1403, 563 U.S. --- [hereinafter, *Halliburton*], Slip Op. at 9 (Jun. 6, 2011).

³ *Halliburton*, at 9.

⁴ The Second, Third and Seventh Circuits had not imposed the Fifth Circuit's loss causation requirement for class certification. See *In re Salomon Analyst Metromedia Litig.*, 544 F.3d 474, 483 (2d Cir. 2008); *Schleicher v. Wendt*, 618 F.3d 679, 687 (7th Cir. 2010); *In re DVI, Inc. Secs. Litig.*, Nos. 08-8033 & 08-8045, 2011 WL 1125926, *7 (3d Cir. Mar. 29, 2011).

⁵ *Halliburton*, at 2.

⁶ *Id.* at 1-2.

⁷ *Id.* at 2.

⁸ *Id.* at 5 (quoting *Basic Inc. v. Levinson*, 485 U.S. 224, 243 (1988)).

⁹ Under Fifth Circuit jurisprudence, the presumption did not come automatically by alleging a price decrease following the release of information that corrects the alleged misrepresentation. Rather, "where multiple items of

negative information [were] released on the same day[.] ... to trigger the presumption plaintiffs must demonstrate that there is a reasonable likelihood that the cause of the decline in price is due to the revelation of the truth and not the release of unrelated negative information." *Greenberg v. Crossroads Sys., Inc.*, 364 F.3d 657, 665 (5th Cir. 2004).

¹⁰*Halliburton*, at 5 (citing *Basic*, at 242).

¹¹ 487 F.3d 261 (5th Cir. 2007).

¹²*Halliburton*, at 2 (citing *Oscar*, 487 F.3d at 269).

¹³*Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, No. 3:02-cv-1152-M, 2008 U.S. Dist. LEXIS 89598, at *68-69 (Nov. 4, 2008).

¹⁴*Oscar*, 487 F.3d at 269.

¹⁵*Archdiocese of Milwaukee Supporting Fund, Inc.*, No. 3:02-cv-1152-M, 2008 U.S. Dist. LEXIS 89598, at *68-69.

¹⁶*Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*, 597 F.3d 330, 384 (5th Cir. 2010).

¹⁷*Id.* at 340-41.

¹⁸*Id.* at 344.

¹⁹*Halliburton*, at 10.

²⁰*Id.* at 4.

²¹*Id.* at 6.

²²*Id.* at 6.

²³*Id.* at 7.

²⁴*Id.* at 9.

²⁵*Id.* at 9.

²⁶*Id.* at 9.

²⁷*Basic*, 485 U.S. at 248 ("Any 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, will be sufficient to rebut the presumption of reliance.").

²⁸*Halliburton*, at 8; *see also Archdiocese of Milwaukee Supporting Fund, Inc.*, 597 F.3d at 335.

²⁹*See, e.g., In re Boston Sci. Corp. Secs. Litig.*, 604 F. Supp. 2d 275, 287 (D. Mass. 2009) ("Although defendants have raised colorable arguments regarding [plaintiffs'] ability to prove loss causation, those issues are more properly addressed on summary judgment or at trial."); *City of Ann Arbor Emps.' Ret. Sys. v. Sonoco Prods. Co.*, 270 F.R.D. 247, 256 (D.S.C. 2010) (concluding that "proof of loss causation is not required at class certification"); *Conn. Ret. Plans & Trust Funds v. Amgen, Inc.*, No. 07-2536, 2009 U.S. Dist. LEXIS 71653, at *33-35 (C.D. Cal. Aug. 12, 2009) (rejecting the Fifth Circuit's requirement as a misreading of the holding in *Basic*).

³⁰*Halliburton*, at 2.

³¹*See, e.g., In re Oracle Corp. Secs. Litig.*, 627 F.3d 376, 383 (9th Cir. 2010) (affirming the district court's grant of summary judgment in favor of the company because plaintiffs developed insufficient evidence "to permit a reasonable jury to conclude that their losses were caused by the market's reaction to Defendants' alleged fraud" rather than the company's poor overall financial health); *In re Omnicom Group, Inc. Secs. Litig.*, 597 F.3d 501, 513-14 (2d Cir. 2010) (affirming grant of summary judgment in favor of defendant where plaintiffs failed to demonstrate evidence of loss causation by failing, *inter alia*, "to show a price decline due to a corrective disclosure" or that an executive's resignation and ensuing negative press was a foreseeable result of the alleged fraud).

³²*Halliburton*, at 4 (citation omitted).

³³*Id.* at 5-6 (citations and quotation marks omitted).

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