

In Narrowly Tailored Opinion, Supreme Court Finds "Loss Causation" Not Required at Class Certification Stage

BY THE SECURITIES LITIGATION AND ENFORCEMENT PRACTICE

Since the United States Supreme Court's 2005 holding in *Dura Pharmaceuticals v. Broudo*, 544 U.S. 336 (2005), legal minds have debated its scope, particularly whether "loss causation" must be proved by securities plaintiffs at the class certification stage. On June 6, 2011, the Court issued a narrow decision in *Erica P. John Fund Inc. v. Halliburton*, 09-1403, 2011 WL 2175208 ("*Halliburton*"), which directly addressed the issue. In a unanimous, but closely cabined opinion written by Chief Justice John Roberts, the Court reversed the decision of the Fifth Circuit, holding that securities plaintiffs need not prove loss causation at the class certification stage.

Halliburton turned on the distinction between two separate elements of a securities fraud claim under Section 10(b) of the Securities Exchange Act of 1934: (1) transaction causation (*i.e.*, reliance); and (2) loss causation. The Court started from the premise that class certification requires that common questions of law or fact predominate over individual questions. See Fed. Rule Civ. Proc. 23(b)(3). On this point, "whether common questions of law or fact predominate in a securities fraud action often turns on the element of *reliance*." *Halliburton*, slip op. at 4 (emphasis added). The Court focused its analysis on that issue, carefully explaining the important distinctions between the reliance requirement and the loss causation requirement in the context of a securities claim.

In doing so, the Court affirmed key elements of its plurality opinion in *Basic, Inc. v. Levinson*, 485 U.S. 224, 245 (1988). The Court explained that "[t]he traditional (and most direct) way a plaintiff can demonstrate reliance is by showing that he was aware of a company's statement and engaged in a relevant transaction – *e.g.*, purchasing common stock – based on the specific misrepresentation." *Halliburton*, slip op. at 4. However, "[r]equiring proof of individualized reliance from each member of the proposed plaintiff class effectively would prevent such plaintiffs 'from proceeding with a class action, since individual issues' would 'overwhelm[] the common ones.'" *Id.* (quoting *Basic*, 485 U.S. at 242).

To alleviate concerns of demonstrating traditional reliance, the Court in *Basic* allowed securities plaintiffs to establish a rebuttable presumption of reliance based on the so-called "fraud-on-the-market" theory. That theory holds that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." *Basic*, 485 U.S. at 246. Because the market "transmits information to the investor in the processed form of a market price," if plaintiffs rely on the market price to reflect the publicly available information about

the company, the plaintiffs may be presumed to have relied on any misrepresentations that were in fact incorporated into the market price. *Id.* at 244, 247.

While declining to establish a strict test, the Court in *Halliburton* enumerated the requirements that “plaintiffs must demonstrate” in order to invoke the fraud-on-the-market theory of reliance in a securities case. The Court asserted that “it is common ground, for example,” that plaintiffs must show (1) that the alleged misrepresentations were publicly known; (2) that the stock traded in an efficient market; and, (3) that the plaintiffs’ initial purchases of the stock were made after the misrepresentations were made to the public, but before the truth was revealed. *Halliburton*, slip op. at 5-6. Ultimately, investors may be presumed to rely on a misrepresentation so long as an efficient market incorporated that misrepresentation into the price of the stock at the time of purchase, *i.e.*, if the investors “purchased the stock at a distorted price.” *Id.* at 7.

According to the Court, where the Fifth Circuit went astray was in requiring plaintiffs to show a subsequent decline in the price of the stock as a result of the correction of the prior misstatement in order to obtain class certification. In so doing, the Court affirmed the core holding of its opinion in *Dura*. The *Halliburton* Court reiterated that, in order to establish the element of loss causation in a securities case, plaintiffs must establish a causal link between the alleged misconduct and the plaintiffs’ losses. *Halliburton*, slip op. at 6. The Court also agreed with the Fifth Circuit’s description of the loss causation requirement, *i.e.*, that the plaintiffs must prove that the decline in the company’s stock was because of the correction of a prior misleading statement and that “the subsequent loss could not otherwise be explained by some additional factors revealed then to the market.” *Id.*

However, the Court found that importing the loss causation requirement into the class certification analysis “is not justified by *Basic* or its logic.” *Halliburton*, slip op. at 6. According to the Court, “[l]oss causation addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock.” *Id.* “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.” *Id.* at 7.

The Court carefully limited its holding in *Halliburton* specifically to reject the proposition that plaintiffs must prove loss causation in order to obtain class certification in a federal securities case. The Court expressly left open a range of other related arguments that may be raised at the class certification stage both with respect to the nature of plaintiffs’ burden to establish the fraud-on-the-market presumption and the defendants’ opportunity to rebut that presumption. Thus, while *Halliburton* provides some clarity regarding the role of a loss causation analysis at the class certification stage, it provides new support for defendants to challenge class certification on related economic issues, such as the need for plaintiffs to establish that the stock traded in an efficient market that incorporated any alleged misstatements or omissions in the price at which they purchased that stock.

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