The Advocate
FOR INSTITUTIONAL INVESTORS

Halliburton II: A Triumph for Investors' Rights and Market Integrity

By Thomas C. Goldstein

The Supreme Court decision preserves investors' right to rely on the integrity of the U.S. securities markets.

In an important victory for investors' rights in *Halliburton Co. v. Erica P. John Fund, Inc. (Halliburton II)*, the United States Supreme Court reaffirmed on June 23, 2014 that investors are entitled to rely on the integrity of the prices of securities that are traded in well-developed markets, like the New York Stock Exchange and NASDAQ. This means that investors who are victims of securities fraud have the right to bring claims under Section 10(b) of the Securities Exchange Act of 1934 and Securities and Exchange Commission (SEC) Rule 10b-5 — the main federal securities-fraud laws — even if they do not read every corporate press release and SEC filing issued by the companies they invest in, but instead rely on market prices. Thus, the *Halliburton II* decision preserves investors' right to rely on the integrity of the U.S. securities markets, and it helps ensure that integrity by exposing companies and their executives to liability if they deceive investors by making false statements.

Halliburton II involved the fraud-on-the-market presumption, which the Supreme Court adopted over 25 years ago in *Basic Inc. v. Levinson*, a landmark investors' rights decision. The presumption holds that material misrepresentations by a company about its business distort the company's securities prices, and any investor who buys securities at the market price is presumed to have relied indirectly on the misrepresentations. This is important because the investor plaintiff's reliance on the defendants' false statements is a required element of securities-fraud claims under Section 10(b) and Rule 10b-5, but many investors do not actually read all of the statements issued by the companies they invest in.

Indeed, many investors follow indexing or other strategies that involve investing in many companies without necessarily reading any of the companies' press releases and SEC filings. Thus, many investors who are victims of securities

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fraud cannot prove that they directly relied on the defendants' false statements and would not be able to recover damages for the fraud if direct reliance were required. The fraud-on-the-market presumption protects investors by allowing them to prove that they indirectly relied on the false statements by relying on the integrity of the market price.

In the *Halliburton* litigation, the investor plaintiff alleged that Halliburton, a large engineering company, made false statements about its potential liability in asbestos litigation, its expected revenue from construction contracts, and its expected benefits from a merger with another company. The Supreme Court heard an earlier appeal in the *Halliburton* case; that appeal concerned whether securities-fraud plaintiffs in class actions must prove at the class-certification stage that defendants' false statements caused their losses in order to benefit from *Basic's* fraud-on-the-market presumption of reliance. The Court ruled in *Halliburton I* in 2011 that plaintiffs do not need to prove loss causation at the class-certification stage.

Wall Street and corporate lobbying groups like the Chamber of Commerce have been campaigning for years, however, to overturn the *Basic* presumption. If *Basic* were overturned, it would be impossible for investors to pursue federal securities-fraud claims as class actions, because one of the requirements for certifying a case as a class action is that common issues affecting all class members in the same way must predominate over individual issues affecting different class members differently. Without the fraud-on-the-market presumption of indirect reliance, individual questions about whether each class member directly relied on defendants' false statements would predominate over common questions, and no class could be certified. Nor could investors pursue securities-fraud class actions under state law, because Congress prohibited most state-law securities-fraud class actions in the Securities Litigation Uniform Standards Act of 1998 (SLUSA), which requires all securities-fraud class actions to be brought under federal law in federal court.

Overturning *Basic* would also cripple many individual federal lawsuits for securities fraud because as noted above, many investors do not read the public statements by the companies they invest in and therefore cannot prove direct reliance on defendants' false statements. While investors could still bring individual actions under state law, the laws of most states require individual reliance for fraud claims. (Some state securities laws, known as blue-sky laws, provide private rights of action that may be attractive for investors that suffer large enough losses to justify individual actions.)

Because of the limited alternatives to federal class actions relying on *Basic* to protect investors from fraud, preserving the *Basic* presumption was critically important for investors' rights. Yet some Justices of the Supreme Court appeared to be sympathetic to the corporate campaign to largely eliminate investors' right to sue for securities fraud by overturning *Basic*. Just last year in *Amgen Inc. v. Connecticut Retirement Plans & Trust Funds*, four Justices — Justices Antonin Scalia,

Anthony M. Kennedy, Clarence Thomas, and Samuel A. Alito, Jr. — signaled that they were considering overturning *Basic*. It also seemed possible that Chief Justice John G. Roberts, Jr. might provide the fifth vote necessary to overturn *Basic*.

After the Supreme Court's decision in *Halliburton I*, the District Court certified the case as a class action, and the U.S. Court of Appeals for the Fifth Circuit affirmed that decision. The Supreme Court then exercised its discretion to grant a *writ of certiorari*, agreeing to review the Fifth Circuit's decision for a second time and consider overturning *Basic*.

But instead of the anti-investor revolution in the law that Wall Street and big business were hoping for, *Halliburton II* turned out to be a vindication of Court precedent and investor rights. In a six-to-three decision by Chief Justice Roberts, joined by Justices Kennedy, Ruth Bader Ginsburg, Stephen G. Breyer, Sonia Sotomayor, and Elena Kagan, the Court rejected big business's plea to overturn the fraud-on-the-market presumption.

As Chief Justice Roberts' opinion recognized, the presumption is based on a fundamental principle of modern financial economics: that the prices of securities traded in well-developed markets generally reflect all publicly available material information about the company eventually, within a reasonable period of time. The Court's decision recognizes that the presumption does not require markets to be perfectly efficient, so debates among economists about exactly how efficient the markets are don't undermine the presumption. Indeed, the Chief Justice quoted one of "the foremost critics of the efficient-capital-markets hypothesis," Nobel economics laureate Robert J. Shiller, as saying: "Of course, prices reflect available information."

About The Author

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Chief Justice Roberts also clarified the law on market efficiency in ways that will be helpful for investors in current and future cases. For example, whereas defense-side experts have often argued that the market for a particular security was not efficient because the market price did not always perfectly equal the company's true fundamental value or

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because the market did not move fast enough in response to new information, the Chief Justice's opinion repeatedly emphasizes that plaintiffs need only show that the stock traded in a "generally efficient market." The Court explained that the fraud-on-the-market presumption is actually a "fairly modest premise that…material statements about companies…affect[] stock market prices"; that "debates about the precise degree to which stock prices accurately reflect public information are…largely beside the point"; and that it is enough for the market price to reflect material information "eventually" and "within a reasonable period."

The Court also correctly held that even investors who explicitly disagree with current market prices, such as value investors, day traders, and arbitragers, still rely on the integrity of the market price and are entitled to rely on the fraud-on-the-market presumption.

The Chief Justice's majority opinion for the Court noted Halliburton's and its corporate supporters' political arguments against securities-fraud class actions, but held that only Congress, not the courts, can undo the *Basic* presumption if Congress so chooses. In fact, Congress has already responded, in SLUSA and the Private Securities Litigation Reform Act of 1995, to big business's policy concerns by adopting a lead-plaintiff selection process that favors institutional investors to control securities class actions, as well as heightened pleading standards and other reforms. Having already thoroughly addressed these issues, Congress is highly unlikely to betray America's investors by abolishing private securities litigation that enables them to recover damages when they are defrauded.

The Court clarified the law by holding that once plaintiffs present evidence of market efficiency at the class-certification stage, defendants may try to rebut plaintiffs' evidence by presenting evidence that defendants' false statements did not actually affect the price of the securities at issue. The Fifth Circuit had held in this

case that defendants could not try to rebut plaintiffs' evidence on a class-certification motion, but only later at summary judgment or trial. The Court therefore vacated the Fifth Circuit's decision and remanded the case to reconsider whether to certify the class after allowing defendants to present their evidence of a lack of price impact.

This does not, however, make the Court's decision favorable for fraudsters. To the contrary, the decision puts the burden of disproving price impact squarely on defendants and gives them no new way of avoiding liability. The Fifth Circuit's holding that defendants could not try to disprove price impact at class certification was an outlier; other circuits already allowed defendants to try to rebut plaintiffs' evidence of market efficiency at class certification. Indeed, a concurring opinion by Justice Ginsburg, joined by Justices Breyer and Sotomayor, notes that because "the Court recognizes that it is incumbent upon the defendant to show the absence of price impact…[t]he Court's judgment…should impose no heavy toll on securities-fraud plaintiffs with tenable claims."

Justices Scalia, Thomas, and Alito concurred in the judgment in *Halliburton II*, but dissented on the principal issue in the case — whether to overturn *Basic*. In an opinion by Justice Thomas, these three Justices argued that the Court should have overturned *Basic* and required securities-fraud plaintiffs to prove that they read and directly relied on defendants' false statements. But the Court's opinion by Chief Justice Roberts ends the long-standing debate over the fraud-on-the-market presumption — plaintiffs are entitled to rely on market prices and aren't required to prove direct, eyeball reliance on defendants' false statements.

Much attention has rightly focused on the importance of this decision for preserving securities-fraud class actions. But the decision is also important for investors who may choose to pursue individual securities-fraud actions but did not read the defendants' false statements, and so must rely on the fraud-on-the-market presumption to establish reliance.

Given that big business had substantial grounds for hoping that the Court would eliminate most private securities-fraud litigation in *Halliburton II*, why did the Court reject its pleas? The reason is that the majority opinion reflects the merits of the securities-law issues in play as well as the importance of preserving prior Court precedent, including *Basic*, which in this case favored the investor plaintiff. Many of the briefs supporting defendants in this case read more like op-eds than legal briefs. The Chief Justice and Justice Kennedy, who were the two swing votes in the case, rejected the highly political campaign by the Chamber of Commerce and its allies to overturn more than a quarter-century of settled law and effectively deny securities-fraud victims any redress whatsoever.

Thus, the relevant legal principles favored investors in this case, and the Supreme Court majority in *Halliburton II* resoundingly vindicated investors' rights and market integrity.

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