U.S. Supreme Court Declines to Overrule Presumption of Reliance

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In *Halliburton Co. v. Erica P. John Fund, Inc.,* 573 U.S. ___ (2014), one of the most highly anticipated securities cases in decades, the Supreme Court declined to overrule the presumption of reliance in Rule 10b-5 securities fraud class actions. Plaintiffs in securities fraud cases must prove several elements: a material misrepresentation or omission, scienter (i.e., intent or recklessness in making the misrepresentation), a connection between the misrepresentation and the purchase or sale of a security, reliance, and loss causation. Ever since the Supreme Court's decision in *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), however, plaintiffs have not needed to prove that they directly and individually relied upon a misrepresentation. Instead, based upon what is known as the "fraud-on-the-market" theory, plaintiffs can satisfy this element by invoking the presumption that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." Id. at 246. Because typical investors who buy or sell securities at the market price do so in reliance on the integrity of that price, reliance on public material misrepresentations affecting that price may be presumed. Thus, rather than directly proving reliance, a securities fraud plaintiff must show that the alleged misrepresentations were public and material, that the stock traded in an efficient market, and that the plaintiff bought or sold the stock between the time of the misrepresentation and the time the truth was revealed.

In *Halliburton*, the defendants argued, among other things, that this presumption should be overruled because it does not comport with recent developments in economic theory. First, the defendants challenged the efficient capital markets hypothesis undergirding the "fraud on the market" theory, arguing that empirical evidence shows that, often, public information is not quickly incorporated into share price. Second, the defendants argued that several classes of investors do not actually rely on the supposed price integrity of public markets. The Supreme Court rejected both of these arguments, holding that the efficiency of the market is a matter of degree and thus a matter of proof, and that the existence of investors for whom price integrity is irrelevant does not alter the validity of the *Basic* presumption. Thus, the Court reaffirmed the "fraud on the market" theory and the presumption of reliance. The Court also held that plaintiffs are not required to directly prove that the alleged misrepresentation had a price impact, as such a requirement would negate the premise and effect of the *Basic* presumption.

Offering some measure of recompense to defendants in securities fraud cases, the Supreme Court noted that the *Basic* presumption is rebuttable, and went on to hold that defendants do not have to wait until the merits stage to rebut the presumption. Instead, under *Halliburton*, defendants may attempt to rebut the presumption at the class certification stage, through the introduction of evidence that the alleged misrepresentation did not in fact have an effect on market price. The Court reasoned that the *Basic* presumption is an indirect proxy for price impact, and that the use of an indirect proxy should not preclude available direct evidence: "While *Basic* allows plaintiffs to establish [price impact] indirectly, it does not require courts to ignore a defendant's direct, more salient evidence showing that the alleged misrepresentation did not actually affect the stock's market price and, consequently, that the *Basic* presumption does not apply." Slip op, p. 21. If the alleged misrepresentation had no impact on market price, then there can be no class action, and each plaintiff would have to prove reliance individually.

In sum, the *Halliburton* decision is somewhat of a mixed bag. It declined to overrule the presumption of reliance, which could have spelled the death knell to securities fraud class actions because of the inability to establish predominance of common questions. On the other hand, it gives defendants the opportunity to avoid class certification—and thus essentially obtain dismissal—if they can successfully rebut the presumption through evidence that the alleged misrepresentation had no effect on market price. This decision could alter the playing field in many cases, as class certification is often a trigger for settlement, and the ability to establish lack of price impact may eliminate some cases that, in the past, would have survived class certification. By the same token, the decision is likely to increase the costs of the class certification phase, as the parties front-load the development of evidence and expert testimony necessary to attempt to show lack of price impact.

If you would like to learn more about this matter, please contact the authors of this alert (**Andrew J. Kolozsvary** at 313-568-5406, or **Samuel C. Damren** at 313-568-6519, or any of the attorneys listed to the left or your Dykema relationship

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