

Corporate Litigation Alert

www.BlankRome.com

June 2011 No. 3

U.S. Supreme Court Holds Loss Causation Not Required For Class Certification

On June 6, 2011, in *Erica P. John Fund, Inc. v. Halliburton Co.*,¹ the United States Supreme Court issued a unanimous decision overruling the Court of Appeals for the Fifth Circuit and expressed the limited holding that investors are not required to prove "loss causation" to obtain class certification in a federal securities fraud case. The Court, however, reiterated its prior holdings that an essential element of any federal securities fraud action is proof that the deceptive conduct actually caused an investment, or economic, loss to the plaintiff(s).

Plaintiffs here alleged that Halliburton and one of its executives inflated Halliburton's stock price through misrepresentations concerning (i) the scope of the company's potential liability in asbestos litigation, (ii) its expected revenue from certain construction contracts, and (iii) the benefits of a merger. Halliburton later made corrective disclosures, which, according to lead plaintiff Erica P. John Fund, Inc. ("EPJ Fund"), caused its stock price to drop.

After the district court denied Halliburton's motion to dismiss, plaintiffs sought class certification pursuant to Federal Rule of Civil Procedure 23. The district court found that all of the general requirements for class certification had been satisfied: the putative class was sufficiently numerous, there were common questions of law or fact, the claims of the putative class representatives were typical, and the putative class representatives would fairly and adequately protect the interests of the class. The district court

declined to certify the class, however, because EPJ Fund failed to establish loss causation. The Fifth Circuit affirmed.

The Supreme Court reversed, rejecting the notion that loss causation has any bearing on class certification issues, including the element of commonality of questions of law or fact. The Court relied on its prior ruling in *Basic v. Levinson*,² in which it held that proof of individualized reliance by each member of a proposed class is not required; if it were, individualized issues would overwhelm common issues, which effectively would prevent plaintiffs from proceeding with class actions. Instead, the *Basic* Court permitted plaintiffs to invoke a rebuttable presumption of reliance based on the fraud-on-the-market theory, under which "the market price of shares traded on well-developed markets reflects all publicly traded information, and, hence, any material misrepresentations." To invoke *Basic's* fraud-on-the-market theory and concomitant rebuttable presumption of reliance, courts require a plaintiff to demonstrate a baseline threshold that: (i) the alleged misrepresentations were publicly known; (ii) the stock traded in an efficient market; and (iii) the relevant transaction took place "between the time the misrepresentations were made and the time the truth was revealed."

The Fifth Circuit added a fourth element by requiring EPJ Fund to establish loss causation. The Supreme Court held that the Fifth Circuit's loss causation requirement was "not justified by *Basic* or its logic." Specifically, loss causation

requires a plaintiff to show that a misrepresentation caused a subsequent economic loss. By contrast, the fundamental premise of *Basic* is that an investor presumptively relied on the misrepresentation as long as it is reflected in the market price at the time of the transaction. As the Court explained, “[t]he 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.” Therefore, the Court concluded, because loss causation is not necessary to establish the efficient market predicate to the fraud-on-the-market theory, it need not be proven at the class certification stage, though it is still a required element of proof at trial in any federal securities fraud case. Notably, Halliburton argued that the Fifth Circuit’s holding should be interpreted not as requiring proof of “loss causation” at the class certification stage, but of “price impact,” *i.e.*, whether the alleged misrepresentations affected the

market price in the first place. The Court disagreed with that reading and declined to address the issue.

This case precludes courts from imposing a greater burden on class action plaintiffs by requiring them to prove the essential element of loss causation at the class certification stage of the proceedings. The decision thus reaffirms that although public companies cannot ultimately be liable for securities fraud absent proof of loss causation, they may still be subjected to a class action even if investors cannot yet prove that the company’s alleged misstatements directly caused their investment loss. It does, however, leave open the possibility that a court could deny class certification based on the lack of proof that alleged misrepresentations impacted the price of the company’s stock.

By: James V. Masella III and Jeremy L. Reiss

1. No. 09-1403 (June 6, 2011).
2. 485 U.S. 224 (1988).

For more information, please contact:

James V. Masella III	212.885.5562 • JMasella@BlankRome.com
Philippe M. Salomon	212.885.5455 • PSalomon@BlankRome.com
Evan H. Lechtman	215.569.5367 • Lechtman@BlankRome.com
Harris N. Cogan	212.885.5566 • HCogan@BlankRome.com
Joseph O. Click	202.772.5966 • Click@BlankRome.com
Catherine A. Armentano	212.885.5461 • CArmentano@BlankRome.com
Michelle Gitlitz Courtney	212.885.5068 • MGitlitz@BlankRome.com
Jeremy L. Reiss	212.885.5245 • JReiss@BlankRome.com