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Supreme Court Rejects Fifth Circuit Requirement that Securities Fraud Plaintiffs Must Prove “Loss Causation” at Class Certification Stage

In a unanimous opinion issued yesterday in *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. ___ (2011), a securities class fraud action, the Supreme Court held that class certification had been improperly denied by the Fifth Circuit based on the absence of “loss causation.” The Court’s holding rejected Fifth Circuit case law dating back to 2007, which had required securities fraud plaintiffs to prove loss causation in order to obtain certification of a class. The Court’s ruling left open, however, whether Halliburton could defeat class certification on remand on other grounds, including by showing that the company’s stock price was not impacted by the fraud alleged by the plaintiffs.

Background

The plaintiff shareholders of Halliburton common stock filed suit, claiming that Halliburton made false and misleading statements about various aspects of its business. The plaintiffs asked the trial court to certify the case as a class action, which would have permitted the plaintiffs to seek damages on behalf of all shareholders who had purchased Halliburton stock during a nearly 2-½-year period. The plaintiffs claimed that they (and a class of shareholders that they sought to represent) bought Halliburton stock at prices that were artificially inflated by the company’s alleged misrepresentations and suffered losses when the “truth” was revealed and the stock price declined.

The trial court denied class certification because investor “reliance” on the company’s alleged false statements would need to be proven on a plaintiff-by-plaintiff basis rather than through evidence applicable to all plaintiffs. The trial court’s ruling was premised on a 2007 decision by the Fifth Circuit which considered what plaintiffs in a securities fraud case must prove to take advantage of the fraud-on-the-market theory, a way of proving reliance through evidence applicable to all plaintiffs. Under the fraud-on-the-market theory, plaintiffs need not show they actually read or were aware of the defendants’ allegedly false statements. Instead, all purchasing shareholders can be presumed to have relied on the integrity of the company’s stock price, which plaintiffs argue was artificially inflated by the allegedly false statements. Fifth Circuit precedent held that to take advantage of this theory at the class certification stage, plaintiffs must prove the defendants’ allegedly false statements actually impacted the company’s stock price. This stock price impact is proven by showing that the stock price declined in response to the “truth” being revealed to the market, a requirement typically referred to as “loss causation.” The Fifth Circuit was the only federal appellate court to impose the requirement that securities fraud plaintiffs must prove loss causation to obtain class certification. The trial court in *Halliburton* found that the plaintiffs failed to prove that the stock price decline in question was caused by the revelation of the alleged “truth” as opposed to other negative information. The trial court therefore denied class certification; the plaintiffs appealed, and the Fifth Circuit affirmed.

The Supreme Court granted *certiorari* to resolve the split between the Fifth Circuit and other federal appellate courts on the following question: Must a securities fraud plaintiff prove loss causation in order to obtain class certification?

Supreme Court Decision

Chief Justice John Roberts, writing for a unanimous Court, answered the question presented, “No,” vacating the Fifth Circuit’s ruling. In doing so, the Supreme Court rejected the Fifth Circuit’s requirement that securities fraud plaintiffs must prove “loss causation” at the class certification stage. The Court in *Halliburton* was clear that the elements of reliance and loss causation are distinct requirements for a securities fraud claim. The Court explained that under the fraud-on-the-market doctrine, “an investor presumptively relies on a defendant’s misrepresentations if that ‘information is reflected in [the] market price’ of the stock at the time of the relevant transaction.” The Court further noted that “[l]oss causation, by contrast, requires a plaintiff to show that a misrepresentation that affected the integrity of the market price *also* caused a subsequent economic loss.” The Court held that the Fifth Circuit’s approach (in requiring a plaintiff to prove loss causation in order to invoke the fraud-on-the-market presumption) contravened the fundamental premise of the fraud-on-the-market theory because “[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.”

The Court remanded the case for further proceedings, noting that if *Halliburton* had other preserved grounds for denying class certification, the Fifth Circuit could revisit them on remand. Among those grounds is an argument raised by *Halliburton*, but which the Court explicitly refused to reach, that class certification could be denied based on the plaintiffs’ failure to show that the alleged fraud impacted the company’s stock price.

Implications of the Decision

Since the Fifth Circuit’s 2007 decision that required plaintiffs to prove loss causation at the class certification stage, plaintiffs have been dissuaded from filing securities fraud lawsuits in Texas federal courts. The Supreme Court’s decision in *Halliburton* was a victory for plaintiffs, and may well change the calculus on whether plaintiffs choose to file more securities fraud class actions in Texas.

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