

Supreme Court Holds Proof of Loss Causation Not Required for Class Certification – But Challenges Remain to the Presumption of Reliance

June 9, 2011

In *Erica P. John Fund, Inc. v. Halliburton Co.*, 563 U.S. ___ (2011) (“*Halliburton*”), the Supreme Court held that proof of loss causation was not required to obtain class certification, unanimously reversing the Fifth Circuit, which had established a contrary rule in *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 269 (5th Cir. 2007), and applied that contrary rule to affirm the denial of class certification in *Erica P. John Fund, Inc.*, 597 F.3d 330 (5th Cir. 2010). Since only the Fifth Circuit had imposed the requirement of proof of loss causation to obtain class certification in securities fraud cases, the Supreme Court’s decision will not change the law in other circuits, such as the Second, which had previously rejected the requirement.

The Supreme Court’s determination in *Halliburton* focused on the requirement, in Rule 23(b)(3) of the Federal Rules of Civil Procedure, “that the questions of law or fact common to class members predominate over any questions affecting only individual members. . . .” In order to show the predominance of common issues, plaintiffs asserting putative class claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 are permitted to invoke a rebuttable presumption of reliance based on what is known as the “fraud-on-the-market” theory, recognized by the Supreme Court in *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988). To obtain the presumption, plaintiffs must show that the alleged misrepresentations were publicly known, that the stock traded in an efficient market, and that the trading took place between the time the misrepresentations were made and the time the truth was revealed. In *Oscar*, the Fifth Circuit added another requirement – proof of loss causation – to the Supreme Court’s list, reasoning that in the absence of such proof, there could be no finding that the market had been affected by the misrepresentation, and the presumption of reliance should not be accepted.

The Supreme Court explained, however, that “[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.” Concluding that “[l]oss causation has no logical connection to the facts necessary to establish the efficient market predicate to the fraud-on-the-market theory,” the Supreme Court reversed the Fifth Circuit.

The defendant Halliburton, which conceded that securities fraud plaintiffs should not be required to prove loss causation to invoke *Basic*’s presumption of reliance or otherwise achieve class certification, argued instead that the Fifth Circuit was actually addressing the concept of “price impact” rather than loss causation. Halliburton theorized that if a misrepresentation does not affect market price, an investor cannot be said to have relied on the misrepresentation when he purchased the stock at that price. The Supreme Court rejected Halliburton’s argument based on the Fifth Circuit’s repeated use of the words “loss causation” and the distinction between that concept and “price impact.” In doing so, however, the Supreme Court was silent as to whether “price impact” should be considered in determining whether the presumption of reliance may be rebutted. Indeed, the Supreme Court stated that “we need not, and do not, address any other question about *Basic*, its presumption, or how and when it may be rebutted.”

Although the Supreme Court’s holding brings the Fifth Circuit into alignment with the other circuits with respect to the absence of a requirement that loss causation be proven to achieve class certification, the use of a price impact analysis to rebut the presumption of reliance under *Basic* remains viable.

Most certainly, defendants in securities fraud class actions in which the presumption of reliance is being invoked should undertake a price impact analysis with respect to all of the alleged misrepresentations and, if no significant price impact is identified, the defense to the presumption should be asserted.