

ClientAlert

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Supreme Court Holds Proof of "Loss Causation" Not Required to Obtain Class Certification of Securities Fraud Claim

In a unanimous opinion issued June 6, 2011 in the case of Erica P. John Fund, Inc. v. Halliburton Co., the U.S. Supreme Court resolved a lopsided Circuit split on the question whether plaintiffs in federal securities cases need to prove loss causation in order to obtain class certification, holding that there was no such requirement.

Several Fifth Circuit cases had held that the requirement that putative class members establish common questions of law and fact cannot be satisfied absent a showing that the plaintiffs relied on the defendant's alleged misrepresentations in transacting in securities—and that this reliance element, in turn (contrary to precedent in the Second, Third, and Seventh Circuits), could not be satisfied on a common, classwide basis absent a showing of loss causation. The Supreme Court held that the Fifth Circuit had essentially conflated the two wholly separate elements of reliance and loss causation, rejecting the idea that loss causation has anything to do with reliance. It thus rejected the Fifth Circuit's requirement that plaintiffs prove loss causation by a preponderance of admissible evidence in order to obtain class certification.

The Decision Under Review

The confusion giving rise to the Supreme Court's decision may stem in part from the fact that the reliance element in securities-fraud claims is sometimes referred to by the term "transaction causation." "Transaction causation" refers to the investor's initial decision to transact in a security, and in the securities-fraud context the requirement is satisfied by evidence that the plaintiff would not have invested in the security but for the defendant's alleged misrepresentations. "Loss causation," on the other hand, refers to the losses suffered by the plaintiff when it sells the security at a diminished price as a result of the truth about the alleged misrepresentations being revealed, usually in the form of a so-called "corrective disclosure," so as to give reason to believe that the loss is attributable to the misrepresentations.

Since the Supreme Court's 2005 decision in Dura Pharmaceuticals, Inc. v. Broudo, 544 U.S. 336 (2005), it has been understood that an inflated purchase price alone is not enough to satisfy the element of loss causation because it is entirely possible for an investor to resell the security at the same inflated price and consequently suffer no damages. To prove loss causation, then, the plaintiff must show both that it sold the security at a deflated price and that the deflated price is attributable to the corrective disclosure and not to other factors, such as unrelated news or market conditions.

Proving transaction causation on a classwide basis, however, poses unique challenges because it can hardly be said of a class of thousands of members that they all had the same subjective motivation for investing in a security. These challenges were mitigated in large measure by the 1988 case of Basic, Inc. v. Levinson, 485 U.S. 224 (1988), where the Supreme Court recognized that "[r]equiring proof of

individualized reliance from each member of [a] proposed plaintiff class effectively would . . . prevent[] [plaintiffs] from proceeding with a class action, since individual issues would . . . overwhelm[] the common ones.” Thus, to preserve the ability of securities plaintiffs to maintain class actions under such circumstances, Basic formulated the “fraud-on-the-market” doctrine, which imposes a rebuttable presumption that plaintiffs who purchased securities on a public market relied on “all publicly available information” about the company, including any misstatements contaminating the market, by virtue of the fact that such information is baked into the security’s market price. The fraud-on-the-market doctrine therefore helps plaintiffs satisfy the class-action requirements that there be questions of fact common to the putative class and that the claims of the class representatives be typical of the claims of the putative class members.

In the Erica P. John Fund litigation, the Fifth Circuit collapsed transaction causation and loss causation into one single causation requirement defined as “the joinder between an earlier false or deceptive statement, for which the defendant was responsible, and a subsequent corrective disclosure that reveals the truth of the matter” which causes a loss that “could not otherwise be explained by some additional factors.” Accordingly, rather than merely requiring the plaintiff to establish reliance by invoking the fraud-on-the-market doctrine, the Fifth Circuit additionally required the plaintiff “to establish a causal link between the alleged falsehoods and its losses.” The Fifth Circuit found that the plaintiff had failed to do so because it had merely pointed to price declines following negative news without showing how the news corrected prior misstatements.

Writing for a unanimous Supreme Court, Chief Justice Roberts stated that the Fifth Circuit’s requirement “is not justified by Basic or its logic,” noting: “[W]e have never before mentioned loss causation as a precondition for invoking Basic’s rebuttable presumption of reliance. The term ‘loss causation’ does not even appear in our Basic opinion. And for good reason: Loss causation addresses a matter different from whether an investor relied on a misrepresentation, presumptively or otherwise, when buying or selling a stock.” The Court further rejected the notion that “an inability to prove loss causation would prevent a plaintiff from invoking the rebuttable presumption of reliance,” reasoning 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.”

Significance of the Supreme Court’s Decision

Because the Supreme Court’s decision merely reaffirms the majority rule as previously stated by the Second, Third, and Seventh Circuits, the decision in Erica P. John Fund may simply solidify a position that already had general acceptance, and thus may not have any substantial effect on the litigation of securities cases at the class-certification stage in the majority of jurisdictions. Ironically, it may not even have any substantial effect on the ultimate outcome of the Erica P. John Fund litigation itself. Nowhere in the Supreme Court’s opinion is there any language to suggest that the Fifth Circuit’s analysis of the loss-causation issue was erroneous or unsound, only that it was improper to make loss causation a requirement of class certification. Presumably, then, the court on remand could certify the class yet still dismiss the case on precisely the same grounds on a motion for summary judgment or after a trial.

There is at least one respect in which the Supreme Court’s opinion may lead to interesting developments in the law beyond the scope of its limited holding, however. Chief Justice Roberts’ opinion emphasizes no fewer than eight times that the fraud-on-the-market theory of Basic is a *rebuttable* presumption. At the end of the opinion, the Court notes that it “need not, and do[es] not, address any other question about Basic,” including “how and when” the presumption may be rebutted. Indeed, there is no precedent that provides clear guidance on that question, likely due to the proportion of securities cases that end in dismissal or settlement before progressing to that stage. Eventually, however, a

defendant in a securities class action that survives the pleading stage may decide that its clearest path to victory is to discover and introduce evidence on an individualized class-member basis to rebut the fraud-on-the-market presumption. Further judicial development in this area thus may still provide a potent new weapon in the securities class action defense lawyer's arsenal.

For More Information

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