REWORKING THE UNWORKABLE: *HALLIBURTON II* AND THE COURT'S REEXAMINATION OF FRAUD ON THE MARKET

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I. INTRODUCTION

In September 2002, the Erica P. John Fund, Inc., brought a securities fraud class action against Halliburton Company and its President, David Lesar.[1] The case reached the Supreme Court for the first time in 2011 on the issue of class certification[2] and was vacated and remanded for further proceedings.[3] Now, nearly twelve years after its initiation, the case returns to the Supreme Court's docket as *Halliburton Co. v. Erica P. John Fund, Inc.*[4] (*Halliburton II*) for yet another examination of issues related to class certification. This time, however, the Court's disposition could signify "the possible death of a cause of action that has been the centerpiece of private securities litigation for the last forty years."[5]

Twenty-six years ago,[6] in *Basic Inc. v. Levinson*,[7] the Supreme

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1. Moore v. Halliburton Co., No 3:02-CV-1152-M, 2004 U.S. Dist. LEXIS 18187, at *9 (N.D. Tex., Sept. 9, 2004), *vacated sub nom.* Erica P. John Fund, Inc. v. Halliburton Co. 131 S. Ct. 2179 (2011).

2. Erica P. John Fund v. Halliburton Co., 131 S. Ct. 2179, 2184 (2011) ("Whether securities fraud plaintiffs must prove loss causation in order to obtain class certification.").

3. *Id.* at 2187.

4. Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. argued Mar. 5, 2014).

5. Donald C. Langevoort, *Judgment Day for Fraud-on-the-Market?: Reflections on* Amgen *and the Second Coming of* Halliburton, Georgetown Pub. Law and Legal Theory Research Paper No. 13-058, Nov. 16, 2013, at 2 (hereinafter *Judgment Day*).

6. *Halliburton* was argued before the Supreme Court on March 5, 2014, almost twenty-six years to the day after the *Basic* opinion, which adopted the fraud on the market rule, was handed down on March 7, 1988.

7. Basic Inc. v. Levinson, 485 U.S. 224 (1988). Only three justices joined Justice Blackmun's opinion in *Basic*; however, because only six justices heard the case, the four-justice opinion constitutes a majority opinion. *See* 28 U.S.C. § 1 ("The Supreme Court of the United

Court adopted "the fraud on the market" rule. This rule presumes that investors who traded in an efficient market relied on all public material information about a company when they purchased its stock. This presumption saves plaintiffs the trouble of proving that they were individually aware of any particular misstatement, and in the case of class actions, opens the door for them to bring suit.

The fraud on the market rule finds its foundation in the efficient capital markets hypothesis — the theory that efficient markets incorporate all material public information into market price.[8] This theory does not discriminate between accurate and misstated information disclosed by company trading in an efficient market. Thus, even misstatements, if material and publicly disclosed, are presumed to be incorporated into an efficient market's stock prices. All investors who traded in an efficient market can be presumed to have relied on all material information, including misstated information.[9]

Halliburton and Lesar, Petitioners in *Halliburton II*, urge the Court to revisit the questionable economic foundation of the fraud on the market rule, and thus overrule *Basic* to the extent that it recognizes this presumption of classwide reliance.[10] Eliminating this presumption would arguably require individualized proof of reliance at class certification, all but preventing plaintiffs from proceeding under the class action mechanism.[11] Despite the potential implications

States shall consist of a Chief Justice of the United States and eight associate justices, any six of whom shall constitute a quorum.").

8. *Id.* at 242.

9. *Id.* at 247.

10. Brief of Petitioners at 3, Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. Dec. 30, 2013) [hereinafter Merits Brief of Petitioner].

11. *See* Amgen, Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1209 (2013) ("*Basic*'s fraud-on-the-market presumption is highly significant because it makes securities-fraud class actions possible by converting the inherently individual reliance inquiry into a question common to the class, which is necessary to satisfy the dictates of [Federal] Rule [of Civil Procedure] 23(b)(3).") (Thomas, J., concurring). Scholars suggest that plaintiffs could nevertheless bring securities class actions under Affiliated Ute v. United States, 406 U.S. 128 (1972), which allows a presumption of reliance in cases alleging material omissions rather than misstatements as the basis of fraud, but the viability of this alternative remains hotly debated. *See* Ann Lipton, *A reasonable facsimile thereof*, L. PROFESSORS BLOGS NETWORK (Feb. 15, 2014) http://lawprofessors.typepad.com/business_law/2014/02/a-reasonable-facsimile-thereof.html ("I don't see how much of a role [*Affiliated Ute*] can play with respect to substituting for *Basic.*"). *See also* Claire Loebs Davis, *Halliburton: Is the Fix as Basic as Alleging Omissions under Affiliated Ute? Or is That Too Cute?,* D&O DISCOURSE (Jan. 28, 2014), http://www.dandodiscourse.com/2014/01/28/halliburton-is-the-fix-as-basic-as-alleging-omissions-under-affiliated-ute-or-is-that-too-cute/ ("*Affiliated Ute* does not offer a quick fix to the potential elimination of *Basic*'s fraud-on-the market presumption."). *See also,*

of such a holding, some members of the Court are eager to revisit *Basic's* controversial holding.[12]

Parts II and III of this commentary introduce *Halliburton II*'s factual and legal background, respectively. Part IV outlines the arguments of Petitioners and Respondents, and Part V builds on these arguments and recommends that the Court overrule *Basic*. Finally, Part V reframes the disagreement between the majority and dissent in *Basic* and predicts, through that lens, that the Court in *Halliburton II* will not overrule *Basic*, but will likely modify *Basic*'s presumption to require plaintiffs to prove that the alleged misstatement or omission actually affected market price in order to earn the benefit of the presumption.

II. FACTUAL BACKGROUND

In this case, Respondents allege that Halliburton used falsified financial statements to mislead the public about "(1) its liability for asbestos claims, (2) its probability of collecting revenue on unapproved claims on fixed-price construction contracts; and (3) the benefits of its merger with Dresser Industries."[13] According to the complaint, defendants understated their exposure to asbestos liability, downplaying the potential adverse impact of pending judgments.[14] They included in its revenues $98 million worth of unapproved and likely unrecoverable claims.[15]

Most significantly, on December 7, 2001, Halliburton's stock price decreased by 42% following the announcement of a $30 million verdict from asbestos claims against the company.[16] Several market analysts reported the price drop as the market's reaction to the news:

12. *See, e.g.*, *id.* at 1204 ("[M]ore recent evidence suggests that the presumption may rest on a faulty economic premise . . . In light of this development, reconsideration of the *Basic* presumption may be appropriate.") (Alito, J., concurring); *id.* at 1206 ("Today's holding does not merely accept what some consider the regrettable consequences of the four-Justice opinion in *Basic*; it expands those consequences from the arguably regrettable to the unquestionably disastrous.") (Scalia, J., dissenting); *id.* at 1209 n.4 ("The *Basic* decision itself is questionable . . . but the court has not been asked to revisit *Basic*'s fraud-on-the-market presumption. I thus limit my dissent to demonstrating that the Court is not following *Basic*'s dictates.") (Thomas, J. dissenting).

13. Brief of Respondents in Opposition to Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit at 9, Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. Oct. 11, 2013) [hereinafter Cert. Brief of Respondents].

14. *Id.*

15. *Id.* at 11.

16. *Id.* at 10.

a manifestation of investors' loss of faith in the company.[17] Nevertheless, analysts disagree about the proportionality of the market's response.[18] While some suggested the 42% drop might have been an overreaction, others withheld judgment.[19]

That day Moody's, one of the nationally recognized credit rating agencies, downgraded Halliburton's credit rating.[20] It is unclear whether the downgrade independently affected Halliburton's stock price or whether it simply reflected the asbestos verdicts.[21] However, as an independent event that could have contributed to the price decrease, the downgrade casts doubt on any event studies seeking to determine the actual impact the asbestos judgments might have had on Halliburton's stock price.[22]

Halliburton stock, which trades on the New York Stock Exchange, is closely monitored and has 848 million shares outstanding.[23] Additionally, a regression analysis of thirty-one instances of Halliburton-specific stock movement suggested that the stock price "as a general matter react[s] promptly to unexpected news."[24] Large fluctuations in Halliburton's stock price, therefore, can be associated as a general rule with material, unexpected information.[25]

III. LEGAL BACKGROUND

A. Section 10(b) and SEC Rule 10b-5

Congress enacted the Securities Exchange Act of 1934 (Exchange

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17. *Id.*
18. *Id*. at app. 23a While both parties refer to the event as a "downgrade," it is unclear whether the downgrade was actually referring to a change in Halliburton's credit, or simply a projection reflecting the likelihood that the rating would remain unchanged. The change actually took place in the "rating outlook," which changed from "stable" to "negative." *Id.* at 25a–26a.
19. *Id.*
20. *Id.* at 11.
21. *Id.* at app. 25a.
22. *See* Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 CHI. L. REV. 611, 627–28 (1985) (identifying intervening causes as complicating factors that render less reliable the event studies used to determine impact of firm-specific news on stock pice).
23. *Id.*
24. *Id.* at 2.
25. *Id.* It is undisputed that plaintiffs may not invoke fraud on the market where the stock did not trade on an efficient market, so plaintiffs allege with that this specific stock traded on an efficient market before they can resort to fraud on the market.

Act)[26] to protect investors from unsavory practices by securities issuers[27] largely as a response to the Great Depression and stock market crash of 1929.[28] The Exchange Act established the Securities and Exchange Commission (SEC) to regulate the capital markets and address excessive speculation, unfair practices, and inadequate disclosure in the markets after the initial offering of securities.[29]

More specifically, Section 10(b) of the Exchange Act prohibits the use of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [Securities and Exchange] Commission may prescribe" and "in connection with the purchase or sale of any security."[30] Pursuant to this authority, the SEC promulgated Rule 10b-5, which proscribes the use of the mail, a national security exchange, or any means or instrumentality of interstate commerce to manipulate or deceive investors in connection with the purchase or sale of a security.[31] In essence, Rule 10b-5 makes any securities fraud actionable, within the full jurisdictional breadth of the Commerce Clause.

B. The Supreme Court's § 10(b) and Rule 10b-5 jurisprudence

Despite the fact that neither Section 10(b) nor Rule 10b-5 explicitly establishes a private cause of action, courts have long inferred a civil claim and remedy for securities fraud based on Section 10 and Rule 10b-5.[32] In *Superintendent of Ins. v. Bankers Life & Casualty Co.*,[33] the Supreme Court recognized this claim for the first time, but relegated its only affirmative statement adopting the private cause of action to a single footnote.[34] Despite this recognition, the Court subsequently restricted the claim by mandating standing requirements in *Blue Chip Stamps v. Manor Drug Stores*[35] and

26. Securities Exchange Act of 1934, Pub. L. No. 73-291, 48 Stat. 881 (codified as amended at 15 U.S.C.A § 78app (West 2013)).
27. *Id.*
28. H. R. REP. NO. 73-1383, at 3 (1934).
29. S. REP. NO. 73-792, at 5 (1934).
30. Securities Exchange Act of 1934 § 10(b), 15 U.S.C.A. §78j (West 2014).
31. Employment of Manipulative and Deceptive Devices, 17 C.F.R § 240.10b-5 (2014).
32. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 197 (1976).
33. 404 U.S. 6 (1971).
34. *Id.* at 14 n.9 ("It is now established that a private right of action is implied under § 10(b).").
35. 421 U.S. 723, 731 (1975) (limiting the right action to actual purchasers and sellers of

imposing a scienter requirement in *Ernst & Ernst v. Hochfelder*.[36] With time, the elements of the cause of action have crystalized into (1) a material misrepresentation, (2) scienter, (3) a connection with the purchase or sale of a security, (4) reliance (or transaction causation), (5) economic loss, and (6) loss causation.[37]

Properly understood, the fourth and sixth elements of the cause of action require the plaintiff to establish two different types of causation. First, "transaction causation," also known as "reliance," addresses the relationship between a misrepresentation and the plaintiff's decision to invest in the company.[38] Second, "loss causation" refers to "a causal connection between the material misrepresentation and the loss,"[39] and is considered commensurate with proximate cause.

Transaction causation requires plaintiffs to prove that they relied on a material misstatement or omission when they engaged in the transaction that caused their loss.[40] In other words, they must prove that but for the material misstatement or omission, they would not have engaged in the transaction that caused their loss.[41] This requirement makes it impossible for securities fraud suits to be brought as class actions because Federal Rule of Civil Procedure 23 conditions class certification on proof that "questions of law or fact common to class members predominate over any questions affecting only individual members."[42] Reliance turns on factual information specific to each class member, causing questions that affect individual members to predominate over common factual issues. [43]

In the 1988 case of *Basic Inc. v. Levinson*, the Court departed from the cautious approach that yielded the scienter and standing requirements in *Blue Chip Stamp* and *Ernst*, and endorsed the "fraud on the market rule."[44] The rule, which had been applied in lower

securities).

36. 425 U.S. at 193 (declining to recognize a right of action for aiding and abetting under Section 10(b) and Rule 10b-5 where the defendant lacked intent to defraud).

37. Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 341•42 (2005).

38. *Id.* at 341•42.

39. *Id.*

40. James Cox, *Understanding Causation in Private Securities Lawsuits: Building on Amgen*, 66 VAND. L. REV. 1719, 1739•40 (2013).

41. *Basic*, 485 U.S. at 245 (suggesting that without fraud on the market, a plaintiff would have to prove "how he would have acted if omitted material information had been disclosed or if the misrepresentation had not been made.").

42. FED. R. CIV. P. 23(b)(3).

43. Amgen Inc. v. Conn.Et. Plans & Trust Funds, 133 S. Ct. 1184, 1193 (2013).

44. Basic, Inc., v. Levinson, 485 U.S. 224, 249–50 (1988).

courts but never before recognized by the Supreme Court, permits trial courts to accept a rebuttable presumption of classwide reliance if plaintiffs can demonstrate that the stock at issue trades in an efficient market.[45]

The adoption of the fraud on the market rule benefitted plaintiffs in two ways. First, it relieved them of the "unrealistic evidentiary burden"[46] of proving how they would have acted had there not been a misstatement or omission. Second, this rule made securities fraud suits practicable by making the class action mechanism available to securities fraud plaintiffs.[47] This proved crucial to the practicability of securities fraud suits because "most claimants' losses are not large enough to justify the expense of their individual prosecution."[48] In these two ways, *Basic* greatly liberalized access to the 10b-5 claim,[49] which generated a dramatic increase in litigation[50] and induced Congress to enact the Private Securities Litigation Reform Act of 1995 (PSLRA).[51] The PLSRA instituted heightened procedural, audit, and disclosure requirements to decrease abusive litigation, reduce coercive settlements, and better detect fraud.[52]

Applying the PLSRA, the Supreme Court held in *Dura Pharmaceuticals, Inc. v. Broudo*[53] that plaintiffs must "adequately allege and prove" loss causation to prevail in a private securities class action.[54] Under *Dura*, it is insufficient for plaintiffs to show that a material misrepresentation inflated market price because the mere distortion of market price at the date of purchase does not prove that the misrepresentation was the proximate cause of an economic loss.[55]

More recently yet, private securities litigation has focused on the interaction among the class certification requirements under the Federal Rule of Civil Procedure 23,[56] the fraud on the market

45. *Id.* at 248 (1988).
46. *Basic*, 485 U.S. at 245.
47. Cox, *supra* note 40 at 1721.
48. Cox, *supra* note 40 at 1721.
49. *Id.* at 261 (admonishing that the Court is making the claim available to too broad a set of plaintiffs) (White, J., dissenting).
50. Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 179 (2009) [hereinafter *Basic at Twenty*].
51. Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67, 109 Stat. 737 (codified as amended in scattered sections of 12, 15, and 18 U.S.C.).
52. *Id.*
53. 544 U.S. 336 (2005).
54. *Id.* at 346.
55. *Id.* at 342.
56. FED. R. CIV. P. 23.

presumption, and the remaining elements of a Section 10(b) claim. This focus has been driven by the question of whether the remaining elements of the claim pose obstacles to class certification. The first time this case reached the Supreme Court in *Erica P. John Fund, Inc., v. Halliburton Co.* (*Halliburton I*) the Court held that plaintiffs can be certified as a class without proving that the defendant's misrepresentation actually caused economic loss because the actual cause of the loss "has nothing to do with whether an investor relied on the misrepresentation."[57]

Further, in *Amgen, Inc. v. Connecticut Retirement Plans and Trust Funds*,[58] the Court also allowed a class to be certified without proof that the alleged misstatements were material.[59] In that case, the Court reasoned that materiality is an objective inquiry that can be established through evidence common to the class.[60] In other words, failure to prove that a misstatement is material does not cause individual issues to predominate; it destroys the 10b-5 claim for all plaintiffs.[61] This inquiry, then, is entirely unlike the reliance inquiry. Under the reliance inquiry, the class's failure to attain the fraud on the market presumption does not end the case. With materiality, however, failure to earn the presumption defeats class certification automatically.[62]

Amgen reveals the gravity of the tension between Federal Rule of Civil Procedure 23 and the fraud on the market rule. Although the Court ultimately held that materiality was a merits issue not appropriate for the class certification stage, three Justices dissented, arguing materiality is necessary to earn the presumption of reliance in fraud on the market cases.[63] Where plaintiffs fail to show that a misrepresentation was material and therefore that it was incorporated into market price under the efficient capital markets hypothesis, fraud on the market fails. Thus, common issues do not predominate and the class cannot be certified.[64] In all likelihood, such claims would be

57. Erica P. John Fund v. Halliburton Co., 131 S. Ct. 2179, 2186 (2011). This differs from the holding in *Dura* where the Court was not concerned with class certification but with success on the merits. *See* Dura Pharms., Inc. v. Broudo, 544 U.S. 336, 338 (2005).
58. 133 S. Ct. 1184 (2013).
59. *Id.* at 1191.
60. *Amgen*, 133 S. Ct. at 1195.
61. *Id.* at 1196.
62. *Id.* at 1199.
63. *Id.* at 1209 (Thomas, J., dissenting).
64. *Id.* at 1209–10 (Thomas, J., dissenting).

"dead on arrival."[65]

Halliburton II picks up where *Amgen* left off. In *Halliburton II*, the Court will decide: (1) whether to overrule or modify *Basic*'s presumption of reliance based on the fraud on the market theory; and (2) whether the defendant may rebut the presumption of reliance in a fraud on the market case at the class certification stage by introducing evidence to disprove the allegation that an alleged misrepresentation distorted the market price of the stock.

IV. ARGUMENTS

B. Petitioners' Arguments

Petitioners contend that the efficient capital markets hypothesis, the foundation for *Basic*'s presumption of reliance, is empirically invalid. Therefore, they urge, the Court should take one of three paths: (1) overrule the presumption;[66] (2) modify it to turn on price impact rather than market efficiency;[67] or, at the very least, (3) allow Petitioners to rebut it at the class certification stage by presenting evidence disproving price impact.[68]

Petitioners begin by identifying and debunking the two premises of the efficient capital markets hypothesis: (1) that efficient markets incorporate all public material misrepresentations into market price and (2) that investors rely on the integrity of this price when they trade on the market.[69]

Petitioners cite empirical evidence suggesting that capital markets do not incorporate all types of public material information at equal speeds or with any degree of rationality.[70] To begin with, investors' attempts to "beat the market" cause price to fluctuate irrationally, severing the link between material information and market price.[71] Additionally, practices such as "noise trading" and computerized trading,[72] which by definition rely on bases other than information

65. *Id.* at 1211 (Thomas, J., dissenting).
66. Merits Brief of Petitioner, *supra* note 10, at 35.
67. *Id.* at 37.
68. *Id.* at 49.
69. *Id.* at 10.
70. *See id.* at 17 (illustrating that market prices respond differently to the disclosure of the same piece of information depending on the method of disclosure).
71. *Id.* at 19.
72. "[Noise trading refers to] trad[ing] on things other than material information about the

about the issuer, also contribute to this irrationality.

Moreover, Petitioners argue, to the extent market efficiency is present, it exists not as a binary condition but on a spectrum.[73] Markets operate efficiently *some* of the time with respect to *some* types of information; therefore, courts are misguided in presuming reliance on all public material misrepresentations.[74] Such a presumption is necessarily both over- and under-inclusive because the general efficiency of a market does not bear directly on whether a particular misrepresentation affected market price.[75] As an example, Petitioners cited the publication of a high profile *New York Times* article detailing a company's progress in cancer research. Following this publication stock price increased from $12 per share to $52 per share despite the fact that the very same information had been published five months earlier in a scientific magazine as well as in a lower profile article in the *New York Times*.[76] If the market had fully incorporated the information when it was first published, it would not have responded to its republication, no matter how prominent.

Accordingly, the sole fact that a market is efficient does not guarantee that it responds to all material public information. A market's efficiency does not automatically bear on whether a particular investor relied on the market price.[77] An investor does not indirectly rely on the information by relying on the market price. To Petitioners, the very fact that investors employ a variety of tactics to "beat the market" and take advantage of its inefficiencies suggests that the second premise of the efficient capital markets hypothesis cannot be absolute.[78] While some investors may trade in reliance on

company . . . . [Computerized trading] us[es] complex algorithms that aim to beat the market, executing trades based on predetermined metrics, not rationally assimilating public disclosures." *Id.* at 19–20.

73. *Id.*

74. *Id.* at 20–21.

75. *Id.* The Petitioners elaborate on this problem with market efficiency:

> If a market for a given stock is generally inefficient or undeveloped, defendants who made affirmative misrepresentations may escape certification and liability, even if the misrepresentation unquestionably distorted the stock's price. . . . Yet, . . . if a stock trades on a market that is generally efficient or well-developed, that says little about whether it was efficient with respect to a particular misrepresentation and whether the market in fact reacted to the information.

Id. at 21.

76. *Id.* at 17. For a detailed description of instances of over- and under-inclusiveness see Lucian A. Bebchuck & Allen Ferrell, *Rethinking Basic*, 69 BUS. L. (forthcoming May 2014) *available at* http://ssrn.com/abstract=2371304.

77. Merits Brief of Petitioner, *supra* note 10, at 17.

78. *Id.* at 16.

market price, others decidedly do not, and that fact alone renders *Basic*'s foundation a fiction.[79]

Petitioners argue in the alternative that if the Court is unwilling to overrule the presumption altogether, it should at least modify it to require plaintiffs to show that the misrepresentation actually distorted market price.[80] This modification would accord not only with modern financial economic theory as described above,[81] but also with Federal Rule of Civil Procedure 23's requirement that plaintiffs prove common issues predominate over issues specific to individual class members.[82]

Were the Court to preserve the presumption as formulated in *Basic*, Petitioners maintain it should nevertheless allow defendants to rebut the presumption at the class certification stage by presenting evidence that the misrepresentations did not affect market price.[83] This is consistent with *Amgen*'s holding that certain elements of a 10b-5, such as materiality, are not relevant to class certification and should not be addressed at that stage.[84] Where plaintiffs cannot prove that the misrepresentation actually distorted market price, they can nevertheless sustain a claim for fraud by presenting direct evidence of reliance.[85] Successful rebuttal of price distortion, therefore, does not immediately defeat a plaintiff's claim but does cause individual issues to predominate over issues common to a class, making the inquiry directly relevant to class certification.[86]

Petitioners advance a variety of policy arguments in support of overruling *Basic*'s presumption. Echoing Justice White's dissent in *Basic*, Petitioners emphasize the difficulties courts face performing the complex and imprecise analysis necessary to establish market

79. *See id.* ("[S]ome investors rely on market integrity and others do not.") (quoting Jonathan R. Macey, *The Fraud on the Market Theory: Some Preliminary Issues*, 74 CORNELL L. REV. 923, 926 (1989)).

80. *Id.* at 37 (citing *Halliburton I* and *Amgen* for the proposition that investor reliance is necessarily premised on a misrepresentation's actually having distorted market price).

81. *Id.* at 38–39; *see supra*, notes 70–75 and accompanying text.

82. *Id.* at 39.

83. *Id.* at 49; *see also* Brief of Law Professors as Amici Curiae in Support of Petitioners at 10–11, Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. Jan. 6, 2013) [hereinafter Brief of Law Professors].

84. *Id.* at 49–50.

85. *See id.* at 52 ("[W]here the defendant directly shows that he misrepresentations did not distort the market price[,] plaintiffs can still establish personal reliance and loss caution in non-fraud-on-the-market cases where misstatements were nonpublic or otherwise did not affect an exchange-traded price.").

86. *Id.* at 53.

efficiency.[87] They also raise concerns about the increased likelihood of *in terrorem* or "blackmail" settlements in Rule 10b-5 litigation:[88] the fear that the cost of litigation after a class has been certified will be so high that it might coerce defendants to settle even where plaintiffs' claims are weak. They further cite the failure of class actions both to compensate investors[89] and to deter fraudulent misrepresentations[90] as compelling reasons to abandon the presumption. Finally, they note, the fact that Congress neither directly created, nor explicitly adopted a private cause of action for securities fraud leaves to the Court the responsibility to amend or overrule the doctrine.[91]

B. Respondents' Arguments

Respondents track their counterparts' arguments closely. They begin by defending *Basic* as correctly decided and addressing policy concerns associated with eliminating the presumption. Next, they maintain that the shortcomings of the efficient capital markets hypothesis does not warrant overruling *Basic*. Finally, they argue that the Court should not modify the presumption to turn on price impact because doing so would contravene recent precedent.[92]

Basic's adoption of the fraud on the market rule came at a time when the efficient market hypothesis enjoyed widespread acceptance.[93] This principle, therefore, informed both the structure of securities legislation and earlier attempts by the Court to execute Congress's legislative intent.[94] Therefore, Respondents continue, overruling *Basic* would have disastrous effects not only for private securities suits,[95] but also for public enforcement of securities laws.[96] First, securities regulation envisions a system of disclosure premised on the idea that information need not be released into the market more than once for the market to respond to it.[97] This regulatory

87. *Id.* at 22.
88. *Id.* at 41 (quoting Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 741 (1975)).
89. *Id.*
90. *Id.* at 44.
91. *Id.* at 32.
92. *See, e.g.*, Amgen v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1204 (2013) (reasoning that materiality could be proved by evidence common to the class).
93. Brief of Respondents at 21, Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. Dec. 30, 2013) [hereinafter Merits Brief of Respondents].
94. *Id.* at 23.
95. *Id.* at 24.
96. *Id.* at 28.
97. *Id.* at 27.

scheme arises from the efficient capital markets hypothesis, and questioning this premise weakens the foundations of the entire system.[98]

Second, event studies, which also rely on an assumption of market responsiveness to information, form the crux of securities fraud prosecutions and other enforcement actions.[99] Similarly here, questioning the economic theory underlying these event studies would jeopardize the viability of public securities enforcement as a response to securities fraud.[100] In short, Respondents do not argue that the efficient capital markets hypothesis is the most adequate premise upon which to base an entire scheme of securities law and securities enforcement procedures. They argue that the securities law and enforcement regime rely so heavily on the theory that calling it into question would deliver a blow to the legitimacy of the system as a whole.

Furthermore, Respondents contend that the market inefficiencies Petitioners point to do not cast doubt on *Basic*'s foundational principle that "individual security prices incorporate information in a reasonably prompt way."[101] *Basic* did not rely on the binary conception of efficiency that Petitioners assign to it. It simply stated the broadly accepted claim that "developed markets generally respond to material information."[102]

Moreover, Respondents argue the Court should decline Petitioner's to modify *Basic*'s presumption to make it turn on price distortion rather than market efficiency. Doing so, Respondents contend would be contrary to the Court's holdings in *Amgen* and *Halliburton I*.[103] The question of price distortion is commensurate to the question of materiality addressed in *Amgen*, which the court held could not be adjudicated at the class certification stage.[104] *Amgen*'s rationale for keeping materiality outside of the class certification stage applies equally to price distortion because both involve

98. *Id.*
99. *Id.* at 28.
100. *Id.*
101. *Id.* at 35; *see also*, Brief of Financial Economists as Amici Curiae in Support of Respondents at 9, Halliburton Co. v. Erica P. John Fund, Inc., No. 13-317 (U.S. Feb. 5, 2014) [hereinafter Brief of Financial Economists].
102. Merits Brief of Respondents, *supra* note 93 at 38. Petitioner's arguments do not distinguish between *fundamental* efficiency and *informational* efficiency, only the latter of which is necessary for fraud on the market to stand. *Id.* at 34 n.17.
103. *Id.* at 50.
104. *Id.*

objective inquiries that require common evidence. Where the inquiry fails, the claim as a whole cannot succeed.[105] Additionally, as a practical matter, proving price impact often requires evidence that can only be obtained through merits discovery.[106]

To conclude, Respondents argue in the alternative that if the Court decides to allow Petitioners to rebut price distortion at the class certification stage, Petitioners bear the burden of proving by a preponderance of the evidence that the misrepresentations did not distort the price of Halliburton stock.[107]

V. ANALYSIS: THE TROUBLE WITH MODIFYING *BASIC*

In *Halliburton II*, the Court will likely modify, but not overrule, *Basic*'s holding—requiring that plaintiffs earn the rebuttable presumption of reliance by demonstrating that the misrepresentation actually distorted market price, rather than by merely demonstrating that the stock at issue traded in an efficient market. This solution purports to address the concerns of market efficiency skeptics while retaining the viability of class actions for section 10(b) plaintiffs, and it has consequently received a great deal of attention.[108] Nevertheless, the modification does not ultimately resolve the shortcomings of *Basic*'s presumption. This section begins by discussing the fundamental problem with the *Basic* presumption and then illustrates how simply modifying the presumption does not sufficiently address that concern.

A. Presumed Reliance is an Inadequate Response to Hardship of Proof.

In his seminal paper, *Basic at Twenty: Rethinking Fraud on the Market*,[109] Donald Langevoort reframes *Basic*'s inquiry into the efficient capital markets hypothesis so as to justify the presumption of reliance in the face of criticism and confusion.[110] According to Langevoort, "the only persuasive, coherent interpretation of *Basic*'s presumption" is the reading that investors rely not on the *accuracy* of

105. *Id.*
106. *Id.* at 55.
107. *Id.*
108. *E.g.,* Lucian A. Bebchuck & Allen Ferrell, *Rethinking Basic*, 69 BUS. L.(forthcoming May 2014) *available at* http://ssrn.com/abstract=2371304; Brief of Law Professors, *supra* note 83 at 28.
109. *See supra* note 50.
110. *Id.* at 151.

market price but on its *integrity*.[111] In other words, investors do not assume that market price reflects the inherent value of a firm, but simply that it reflects material public information and that that information is not fraudulent.[112] As Langevoort notes, however, the assumption that market price is not distorted by fraud is just as irrational as the assumption that market price reflects inherent value.[113]

Nevertheless, *Basic* can stand if understood as granting investors an entitlement to rely on price integrity as a matter of policy rather than as a matter of sound economic judgment.[114] Put differently, *Basic* can be understood as granting investors the *right* to believe that corporations are not manipulating information to distort market price. According to Langevoort, this right to rely on corporate statements parallels the right to rely on statements by strangers underlying common law fraud.[115] Just as there is no reason to trust strangers, there is no reason to trust markets, but courts allow people to trust both strangers and markets by creating a cause of action for fraud.[116] Langevoort calls this "an act of juristic grace."[117]

However, Langevoort does not address the difference between the right to rely on corporate statements and actual reliance on corporate statements. Someone who does not believe a stranger's lies cannot be said to have acted on those lies and should not have recourse for fraud either in a face-to-face interaction or in connection with the purchase of a security.[118] This highlights the fundamental problem with *Basic* reliance: it takes an undeserved right to rely on price integrity, which courts have granted to every investor, and

111. *Id.* at 161. Langevoort notes that this reading may very well be at odds with the Court's intention in *Basic*, but it is nevertheless the only convincing reading of their opinion. *Id.*

112. *Id.* at 161.

113. *Id.* at 160.

114. *See id.* at 161 ("Whether or not it is what he was thinking, [Justice Blackmun's policy-making justification] really is the only persuasive, coherent interpretation of *Basic*'s presumption.").

115. *Id.*

116. *Id.*

117. *Id.*

118. *See* Basic Inc. v. Levinson, 485 U.S. 224, 249 (1988) (noting plaintiffs who sold shares because of other concerns despite believing (1) Basic's statements were false; (2) Basic was engaged in merger discussions, and (3) consequently that Basic stock was artificially underpriced, "could not be said to have relied on the integrity of a price he knew had been manipulated"); *see also id.* at 261 ("[I]t is possible that a person who heard the first corporate misstatement and disbelieved it . . . may still be included in the plaintiff-class on remand. How [such a person] can say that he was 'defrauded' by [relying] on the 'integrity' of the market price is beyond me.") (White, J. dissenting).

extrapolates from it the assumption that every investor did, in fact, rely on price integrity. Even a showing that a misrepresentation distorted market price does not guarantee that all members of a class actually relied on that price.

In arguing that presumed reliance is an act of juristic grace comparable to the act of juristic grace that created common law fraud, Langevoort misapplies his own analogy. The act of juristic grace commensurate to the creation of the common law fraud doctrine occurred long before *Basic* when the Court first invented a private cause of action for securities fraud. [119] Presumed reliance, therefore, is not so much an act of juristic grace as the first of many attempts by the Court, and later Congress, to mend that tattered cloak it placed over the shivering shoulders of securities fraud plaintiffs back in 1971.

While the presumption does make it significantly easier for plaintiffs to bring class action suits for securities fraud, it does more than simply recognize these plaintiffs' right to trust the market in the way individuals may trust each other. Rather than merely granting investors a right to sue someone who has lied to them—as the common law would do—*Basic*'s presumption grants them the right to sue someone who has lied to a third party.

B. A Presumption of Reliance Requires Impermissible Burden-Shifting and Procedural Complications.

Nevertheless, Langevoort is correct in saying that the *Basic* Court made a policy decision in adopting the presumption of reliance. It chose to alleviate but not fully abolish plaintiffs' burden of proof by allowing them to satisfy the reliance element through indirect evidence of market efficiency.[120] In Justice Blackmun's own words, "[r]equiring a plaintiff to show a speculative state of facts . . . would place an unnecessarily unrealistic evidentiary burden on the Rule 10b-5 plaintiff who has traded on an impersonal market."[121] The Court chose, therefore, to shift this "unnecessarily unrealistic evidentiary burden"[122] from the plaintiff, its rightful bearer, to the defendant, who

119. Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 13 (1971) (recognizing a private cause of action for securities fraud based on § 10(b) and Rule 10b-5).

120. William W. Bratton & Michael L. Wachter, *The Political Economy of Fraud on the Market*, 160 U. PA. L. REV. 69, 73–74 (2011).

121. *Basic*, 485 U.S. at 245.

122. *Id.*

is even more ill-equipped to carry it. The irony of this decision does not appear to be entirely lost on Justice Blackmun, who went to great lengths to justify this choice.

Presumptions, he wrote, "assist courts in managing circumstances in which direct proof for one reason or another is rendered difficult,"[123] and they are "useful devices for allocating the burden of proof between parties."[124] Justice Blackmun cited *McCormick on Evidence* for the proposition that presumptions can be used to allocate the burden of proof.[125] However, that very source also indicates that the considerations relevant to the initial assignment of the burden bear also upon the decision to shift it.[126] A court should place the burden on the party who (1) has better access to a piece of information and who (2) alleges the more unlikely event.[127]

Here, both considerations weigh against presuming reliance. First, the defendant in a securities fraud class action can proffer no evidence as to whether any class member was aware of or believed a misstatement. Because of the nature of the evidence required to prove reliance, demanding that the defendant *disprove* reliance requires them to produce evidence practically available only to the plaintiff. While proving *actual* reliance might be "unnecessarily unrealistic" for a group of plaintiffs acting as a class, the same requirement verges on the impossible when placed on the defendant.

Second, although Justice Blackmun struggled to imagine an investor who does not rely on market integrity,[128] Langevoort suggests that a reasonable investor maintains a healthy cynicism about the market price.

> Fraud and manipulation are predictable enough that it would be foolish for anyone simply to assume that a stock price has integrity. In an efficient market, the inevitable risk of fraud is priced and investors are compensated for taking on the risk—the market is

123. *Id.*
124. *Id.*
125. *Id.*
126. EDWARD W. CLEARLY, ET AL., MCCORMICK ON EVIDENCE § 343 (3d ed. 1984).
127. *Id.* at § 337.
128. *Basic*, 485 U.S. at 246–47.

not assuming its absence.[129]

In the absence of the presumption, the rational investor, aware that market price is likely distorted by fraud, might be more cautious or more diligent in conducting market research before accepting the "integrity" of market price. After all, the presumption allows an investor to sue, even if he never read or heard the alleged misstatement.

Aware of the unsavory consequences of this burden-shifting, Justice Blackmun emphasized time and again the fact that the presumption of reliance is a rebuttable one, such that it does not destroy all defendants' hopes of success.[130] To be fair to Justice Blackmun's formulation of the presumption, courts must allow defendants to present evidence to rebut the presumption and prevent the plaintiff from establishing it.[131] However, the Court has held that hearing such evidence contravenes the Federal Rules of Civil Procedure because it forces merits issues, which belong in trial or at summary judgment, into the class certification stage.[132]

Courts are therefore caught between a rock and a hard place, forced to circumvent the Federal Rules of Civil Procedure if they wish to remain faithful to *Basic*. This tension was evident in *Amgen*[133] and *Halliburton I*,[134] and the Court's solution was fundamentally unsatisfactory. In an attempt to avoid holding a quasi-trial at the class certification stage, the Court manipulated the class certification inquiry, effectively rendering the presumption unrebuttable, shifting the burdens of proof and persuasion entirely to the defendant, and doing violence both to Federal Rule of Civil Procedure 23 and to the holding in *Basic*.[135]

129. Langevoort, *supra* note 50, at 160.

130. *Basic*, 485 U.S. at 226, 229, 242, 245, 248, 248 n.28, 249, 250 (employing the term "rebuttable presumption" or otherwise addressing the fact that the defendant may rebut the presumption of reliance).

131. *Id.* at 250.

132. Amgen v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184, 1204 (2013).

133. *Id.* at 1194.

134. Erica P. John Fund v. Halliburton, 131 S. Ct. 2179, 2183 (2011) ("The question presented in this case is whether securities fraud plaintiffs must also prove loss causation [an affirmative element of the claim] in order to obtain class certification.").

135. *Amgen*, 133 S. Ct. at 1206 ("The Court today allows plaintiffs to obtain certification of

VI. CONCLUSION

In *Basic*, Justice Blackmun unequivocally abrogated all responsibility for the economic underpinnings of the fraud on the market rule. "Our task," he wrote, "is not to assess the general validity of the theory, but to consider whether it was proper for the courts below to apply a rebuttable presumption of reliance, supported in part by the fraud-on-the-market theory."[136] This carefully crafted sentence holds the key to the Court's opinion by juxtaposing the economic invalidity of the theory with the propriety of the presumption. To Justice Blackmun, the validity of the efficient capital markets hypothesis was not a necessary predicate for the presumption of reliance to be proper. In fact, the hypothesis need only be generally acceptable in order to buttress the presumption: "we need only believe that market professionals *generally* consider *most* publicly announced material statements about companies, thereby affecting stock market prices."[137]

Therein lies the fundamental disagreement between Justice Blackmun and Justice White. Justice Blackmun viewed the presumption as a matter of equity.[138] He was concerned that the reliance requirement placed too heavy a burden on securities fraud plaintiffs, so he applied an equitable remedy to reallocate the burden.[139] Beyond that, he engaged in a relatively cursory analysis of the hypothesis consistent with his assertion that it was not for the Court to examine.

Justice White, on the other hand, viewed the issue primarily as a matter of law and embarked on a vehement attack on the fraud of the market rule. He questioned its economic foundation,[140] its pedigree as judicially-created doctrine lacking affirmative Congressional

securities-fraud class actions without proof that common questions predominate over individualized questions of reliance, . . . by all but eliminating materiality as one of the predicates of the fraud-on-the-market theory . . . .") (Thomas, J., dissenting).

136. *Basic*, 485 U.S. at 242.

137. *Id.* at 247 n.24 (emphasis added).

138. Thus characterized, Justice Blackmun's view of the reliance presumption is consistent with his broader conception of the § 10(b) and Rule 10b-5 private cause of action articulated in his dissent in *Blue Chip Stamps*. In that opinion, he rebuked the majority for barring plaintiffs who did not actually purchase or sell securities from the private cause of action under § 10(b) and Rule 10b-5 and accused his fellow Justices of "exhibit[ing] a preternatural solicitousness of corporate well-being and a seeming callousness toward the investing public." Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 762 (1975).

139. *Basic*, 485 U.S. at 245.

140. *Id.* at 255–56.

approval,[141] and its discord with broader Congressional policy favoring disclosure.[142]

The very same dispute underlies *Halliburton II*. However Petitioners in *Halliburton II* present the Court with a third option: upholding the presumption of reliance but replacing the efficiency predicate with an inquiry into actual price impact. Taking this position would perhaps mollify the equity-driven members of the Court, but it would also leave fundamentally unaltered the uneasy compromise that the *Basic* presumption represents. Nevertheless, it is the most likely result given the potentially disastrous consequences that abolishing *Basic* reliance might have on the viability of class actions for securities litigation. While the Court may be prepared to revisit the economic underpinnings of the fraud on the market rule, they are less likely unwilling to do so at the expense of the class action mechanism.

141. *Id.* at 257.

142. *See id.* at 259. *Amgen*'s evaluation of the congressional intent reads:

> [T]he federal securities laws are intended to put investors into a position from which they can help themselves by relying upon disclosures that others are obligated to make . . . If we say that a plaintiff may recover in some circumstances even though he did not read and rely on the defendants' public disclosures, then no one need pay attention to those disclosures and the method employed by Congress to achieve the objective of the 1934 Act is defeated.

Id. (quoting *Shores v. Sklar*, 647 F.2d. 462, 483 (5th Cir. 1981) (Randall, J., dissenting)).