

U.S. SUPREME COURT TO REVIEW FIFTH CIRCUIT'S CONTROVERSIAL LOSS CAUSATION RULES FOR SECURITIES CLASS ACTIONS

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Securities class actions are “the 800-pound gorilla” of federal class action practice.¹ For this reason, the U.S. Supreme Court has devoted considerable attention to securities litigation issues in recent years. Since 2007, the Roberts Court has addressed the territorial reach of the federal securities laws, the ability to pursue claims against secondary actors, requisite pleading standards, and the statute of limitations.² Two more cases are awaiting decision this term.³ Next on the docket is the controversial *Halliburton* case.

Traditionally, the key battleground in securities class actions has been the pleading stage. If a plaintiff could survive a motion to dismiss, there was little that could be done to stop the class action freight train. As a result, courts have stringently applied Federal Rule 12(b) and PSLRA pleading standards as a gatekeeping mechanism to prevent unmeritorious actions from moving forward with *in terrorem* effect.

In the Fifth Circuit, however, there is a new battleground. In a series of decisions beginning in 2007, the Fifth Circuit has erected a barrier to plaintiffs at the class certification stage. Alone among the circuit courts, the Fifth Circuit requires plaintiffs to prove “loss causation” in order to certify a class. Not surprisingly, the plaintiffs’ bar has roundly criticized the Fifth Circuit standard. But so have many others, including other circuit courts. In August 2010, Judge Easterbrook of the Seventh Circuit expressly disapproved of the Fifth Circuit’s “go it alone approach.” The Second Circuit also has rejected the Fifth Circuit standard.

On January 7, 2011, the Supreme Court granted *certiorari* in *Erica P. John Fund, Inc. v. Halliburton Co.*, to resolve this circuit conflict. The Supreme Court will decide the following questions: 1. whether a plaintiff in a securities fraud action must establish loss causation by a preponderance of the evidence at the class certification stage; and 2. whether the Fifth Circuit improperly considered the merits of the underlying litigation at the class certification stage. Oral argument is scheduled on April 25, 2011.

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This article, written by experienced Fifth Circuit practitioners, analyzes the issues presented in *Halliburton* and the evolution of the controversial Fifth Circuit standard.

I. THE LOSS CAUSATION DOCTRINE

Loss causation has been a hot topic in securities litigation since the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*,⁴ especially in the Fifth Circuit. This is hardly surprising, since it was the Fifth Circuit that effectively created the doctrine in 1981. In *Huddleston v. Herman & MacLean*,⁵ the Fifth Circuit announced that loss causation was an essential element of a claim under section 10(b). The loss causation requirement is met "only if the misrepresentation touches upon the reasons for the investment's decline in value."

The *Huddleston* court explained its reasoning as follows:

Causation is related to but distinct from reliance. Reliance is a *causa sine qua non*, a type of "but for" requirement: had the investor known the truth he would not have acted. Causation requires one further step in the analysis: even if the investor would not otherwise have acted, was the misrepresented fact a proximate cause of the loss? The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss. The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value. If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule is not permitted.

To emphasize the point, the court added a colorful example:

For example, an investor might purchase stock in a shipping venture involving a single vessel in reliance on a misrepresentation that the vessel had a certain capacity when in fact it had less capacity than was represented in the prospectus. However, the prospectus does disclose truthfully that the vessel will not be insured. One week after the investment the vessel sinks as a result of a casualty and the stock becomes worthless. In such circumstances, a fact-finder might conclude that the misrepresentation was material and relied upon by the investor but that it did not cause the loss.

Other courts, including the Ninth Circuit, subsequently adopted a more lenient approach to loss causation. Twenty-five years after *Huddleston*, the Supreme Court finally addressed loss causation and resolved the circuit split. In *Dura*, the Supreme Court rejected the Ninth Circuit's contrary approach and essentially adopted the Fifth Circuit's longstanding rule requiring proof of a causal connection between the alleged misrepresentations and the subsequent decline in the stock price.

Dura did not address whether loss causation should be considered at the time of class certification. But it did lay the groundwork for a new, more powerful loss causation defense. And the Fifth Circuit has followed through with a vengeance.

II. THE SUPREME COURT'S DECISIONS IN *BASIC* AND *DURA*

Securities claims involving large, publicly-traded companies create unique litigation issues. Two key issues involve proof of the “reliance” and “loss causation” elements of a securities fraud claim -- i.e., proof that the alleged fraud caused the plaintiff to purchase or sell the disputed security (reliance), and proof that the fraud proximately caused the plaintiff’s economic loss (loss causation).⁶ In *Basic*,⁷ the Supreme Court ruled that reliance can be presumed for a plaintiff who purchased or sold a company’s securities in an efficient market (this is known as the “fraud-on-the-market presumption”). Seventeen years later in *Dura*, the Court held that a plaintiff must prove his losses were caused by the alleged fraud, as opposed to external events such as adverse market conditions.

The Fifth Circuit’s loss causation jurisprudence stems from the Supreme Court’s seminal decisions in *Basic* and *Dura*.

A. *Basic Inc. v. Levison*

The *Basic* case arose from alleged misrepresentations and omissions by Basic Inc. and its officers concerning a possible merger. The plaintiff brought a putative class action, claiming that Basic’s shareholders were injured by selling the company’s shares at artificially depressed prices in a market affected by Basic’s misleading statements. The lower courts concluded that the plaintiffs were entitled to a presumption of reliance on the company’s public statements under a “fraud-on-the-market” theory. The Supreme Court agreed.

Justice Blackman, writing for the Court, noted that “[t]he modern securities markets, literally involving millions of shares changing hands daily, differ from the face-to-face transactions contemplated by early fraud cases,” and that the reliance requirement of Section 10(b) claims must encompass this dynamic. He also noted that Congress’ intent in drafting the 1934 Exchange Act was that “the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.”

The Court recognized that “[r]equiring proof of individualized reliance from each member of the proposed plaintiff class” often would “prevent [plaintiffs] from proceeding with a class action, since individual issues would...overwhelm the common ones.” As a result, the Court approved the fraud-on-the-market theory to allow plaintiffs to overcome this obstacle.

The doctrine establishes a rebuttable presumption that in an efficient market, material misinformation affects the market price. Plaintiffs are entitled to the presumption when (1) a defendant made a public material misrepresentation, (2) the defendant’s shares were traded in an efficient market, and (3) the plaintiffs traded between the time that the misrepresentations were made and the time the truth was revealed.

B. *Dura Pharmaceuticals, Inc. v. Broudo*

In *Dura*,⁸ the Supreme Court resolved a split among the circuit courts over the meaning of the loss causation requirement. In contrast to the more rigorous Fifth Circuit standard, other courts had adopted a more lenient approach to loss causation. Those courts concluded that loss causation could be established merely by showing that the plaintiffs paid an inflated price for their shares, regardless of whether the alleged fraud actually caused a stock price decline. For years, therefore, there was a conflict among the circuits on this critical issue.

In *Dura*, the Supreme Court reviewed a Ninth Circuit decision holding that loss causation was satisfied if the plaintiff could prove that "the price at the time of purchase was inflated because of the misrepresentation." In a unanimous decision authored by Justice Breyer, the Supreme Court rejected the Ninth Circuit's price inflation theory of loss causation. Instead, the court held that a plaintiff must prove that there was a causal connection between the alleged misrepresentations and the subsequent decline in the stock price.

The Supreme Court emphasized that the objective of the securities laws is "not to provide investors with broad insurance against market losses, but to protect them against those economic losses that misrepresentations actually cause." The Court also noted that "the logical link between the inflated share purchase price and any later economic loss is not invariably strong." A subsequent resale of the stock at a lower price may result from "changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price." The Court, therefore, made clear that a misrepresentation that merely "touches upon" a loss is insufficient. The misrepresentation must *cause* the loss.

III. THE FIFTH CIRCUIT AFTER *DURA*

After *Dura*, the Fifth Circuit began issuing a series of decisions designed to give teeth to the "loss causation" doctrine as a defense to securities class actions. The decision in *Halliburton* is the culmination of these decisions.

A. *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*

In *Oscar*,⁹ the Fifth Circuit vacated the district court's certification of a securities class action class "for want of any showing that the market reacted to the corrective disclosure." Noting that economic theory does not support the notion that every material misrepresentation moves a stock that is trading in an efficient market, the court found that mere proof of a material misstatement is insufficient to invoke the fraud-on-the-market presumption of reliance. Rather, the court held that plaintiffs are required to show that the misstatements themselves *actually moved* the market.

After weighing the evidence, including expert reports from both sides, the court concluded that the factual conclusions of the plaintiffs' expert linking the defendant's fraud to the stock price movement were "untenable." Accordingly, the court held that the plaintiffs had not established loss causation and could not invoke the fraud-on-the-market doctrine.

Noting the policy concerns articulated in *Dura*, the court refused to “ignore the *in terrorem* power of certification, [while] continuing to abide the practice of withholding until ‘trial’ a merit inquiry central to the certification decision, and failing to insist upon a greater showing of loss causation to sustain certification.”

The court explained that “because Rule 23 mandates a complete analysis of fraud on the market indicators, district courts must address and weigh factors both for and against market efficiency.” Under *Basic*, a defendant may rebut the presumption of reliance through “[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price.” Because of the low burden on defendants to make “any showing” that would undermine the market presumption, the court held that a plaintiff must affirmatively prove his entitlement to invoke the doctrine.

B. *Luskin v. Intervice-Brite, Inc.*

On its face, the holding in *Oscar* was limited to “instance of simultaneous disclosure of multiple pieces of negative news.” In *Luskin*,¹⁰ the Fifth Circuit extended the doctrine to cases involving only a single negative disclosure.

The plaintiffs argued that *Oscar*’s holding should be limited to situations in which several pieces of bad news are disclosed simultaneously. In such cases, a company’s stock price may fall for reasons that are wholly unrelated to the alleged scheme, and it makes sense that plaintiffs would be required to establish a connection between the market decline and the defendants’ alleged fraud. But in cases involving a single negative disclosure, followed by a drop in the defendant company’s stock price, plaintiffs argued that loss causation should be presumed.

The Fifth Circuit disagreed, holding that *Oscar* required proof of loss causation even when there is a single negative disclosure. The court noted that in such a case, the plaintiff’s proof “should be even easier.” Because the district court did not apply *Oscar* at the class certification stage, the court remanded the case and did not opine on whether the plaintiff’s evidence was sufficient to meet the *Oscar* standard.

C. *Alaska Electrical Pension Fund v. Flowserve Corporation*

In *Flowserve*,¹¹ the district court had applied a rigorous *Oscar* analysis and rejected the plaintiffs’ motion for class certification. Surprisingly, the Fifth Circuit reversed the district court’s decision.

In a *per curiam* opinion authored by a panel that included retired Supreme Court Justice Sandra Day O’Connor, the court reiterated prior Fifth Circuit precedent holding that Rule 23 requires plaintiffs to establish loss causation by a preponderance of the evidence at the time of class certification. But the court was troubled by the district court’s “fact-for-fact” disclosure standard, which required proof that the “corrective disclosure” specifically reveal the alleged fraud.

The court found such a rule “effectively does away with the fraud-on-the-market theory of reliance” and would allow defendants to “defeat liability by refusing to admit the falsity of its prior misstatements. And if a ‘complete’ corrective disclosure were required, defendants could

‘immunize themselves with a protracted series of partial disclosure.’” The panel pulled back from this extreme, instead adopting a rule that requires plaintiffs merely to prove that subsequent disclosures concern the same subject matter as the alleged fraud.

Notably, the court concluded its opinion with the following statement: “To be successful, a securities class-action plaintiff must thread the eye of a needle made smaller and smaller over the years by judicial decree and congressional action. Those ever higher hurdles are not, however, intended to prevent viable securities actions from being brought.”

Not surprisingly, this statement raised eyebrows among Fifth Circuit practitioners, in part because it signaled a potential shift in the court’s approach, and in part of the belief that the opinion may have been authored by Justice O’Connor.

D. *Fener v. Operating Eng’rs Constr. Indus. & Misc. Pension Fund (LOCAL 66) (the “Belo” case)*

In *Belo*,¹² the Fifth Circuit signaled that it had no intention of backing away from its previously articulated loss causation standards. The *Belo* case centered around the overstatement of the *Dallas Morning News*’ circulation numbers. Plaintiffs submitted 100 pages of expert testimony in support of their class certification motion. Defendants countered with expert testimony that Belo’s press release contained three distinct parts: “DMN’s circulation decrease resulted from (1) fraudulent overstatements; (2) changes in DMN’s methodology; and (3) industry-wide decline in newspaper circulation.” Based on an examination of 132 analyst reports, the defendants argued that Belo’s stock price dropped primarily because of “the non-fraudulent disclosures instead of the fraudulent one.”

The district court acknowledged that Belo had misstated its circulation numbers, but it refused to certify a class. The court found that the SEC filings, stock price charts, and analyst reports relied on by the plaintiff showed “little more than well-informed speculation.” Instead, the court held “the testimony of an expert - along with some kind of analytical research or event study - is required to show loss causation.”¹³

The Fifth Circuit upheld the denial of class certification. The court noted that the plaintiff’s expert erred in looking at how the “stock reacted to the *entire bundle* of negative information,” rather than considering the “evidence linking the *culpable* disclosure to the stock-price movement.” The court held that when there are multiple sources of negative information, plaintiffs must establish by a preponderance of the evidence that it was the negative truthful statement, and not other sources of negative information, which caused the decline in the share price.

IV. THE HALLIBURTON CASE

A. The Fifth Circuit

In the underlying case, *Archdiocese of Milwaukee Supporting Fund, Inc. v. Halliburton Co.*,¹⁴ the plaintiff filed suit against Halliburton for allegedly falsifying its financial results, survived a motion to dismiss, and subsequently moved for class certification. The district court determined that the proposed class satisfied Federal Rule of Civil Procedure 23 as to numerosity,

commonality, typicality, and adequacy of the named plaintiff as a class representative. The court likewise concluded that a class action “would be the superior method for adjudicating claims of these class members.” But it denied the certification motion because the plaintiff had failed to prove loss causation by a preponderance of the evidence.

The Fifth Circuit affirmed, noting that it was bound by the standard established three years earlier in *Oscar*. The court noted that the plaintiff’s own expert analysis showed that the price of Halliburton’s stock never increased following any of the alleged misrepresentations, although there were stock price decreases following allegedly corrective disclosures. The court found that without proof that the alleged misrepresentations and omissions caused Halliburton’s stock price to increase, the decrease following the corrective disclosures was insufficient to show loss causation.

The *Halliburton* case is not an outlier, nor did it further develop the law in the Fifth Circuit. It is entirely consistent with the Fifth Circuit’s approach in numerous cases since 2007. But now, of course, the Supreme Court will finally have an opportunity to assess the Fifth Circuit’s approach to class certification in securities cases in the aftermath of *Dura*.

B. The Circuit Split

The Seventh Circuit stands at the opposite end of the spectrum from the Fifth Circuit. In *Schleicher v. Wendt*,¹⁵ the Seventh Circuit explicitly rejected the Fifth Circuit’s decision in *Oscar Private Equity*, arguing that loss causation was not appropriate for class certification and that the Fifth Circuit’s standard would “make certification impossible in many securities suits.” The opinion went on to criticize other courts for requiring plaintiffs to establish materiality and falsity as a condition to class certification. In the Seventh Circuit, issues such as loss causation, materiality, and falsity are “issues on the merits,” which should not be resolved at the class certification stage. The *Schleicher* court held that if the defendants operated in an efficient market, investors are entitled to “use the fraud-on-the-market doctrine as a replacement for person-specific proof of reliance and causation.”

The Second Circuit has taken a middle-ground approach. In the case of *In re Salomon Analyst Metromedia Litigation*,¹⁶ the Second Circuit vacated the district court’s class certification order because the defendants were not given an opportunity to rebut the fraud-on-the-market presumption. The court noted that “plaintiffs do not bear the burden of showing an impact on price” because the “point of *Basic* is that an effect on market price is presumed based on the materiality of the information and a well-developed market’s ability to readily incorporate that information into the price of securities.” But the court also noted that “[t]he *Basic* Court explained that a successful rebuttal *defeats* certification by defeating the Rule 23(b)(3) predominance requirement.” Accordingly, the Second Circuit remanded the case, so that the defendants would have any opportunity to present rebuttal evidence. The Second Circuit therefore permits some consideration of the merits at the class certification stage, if the defendant can demonstrate “that the market price was not affected by the alleged misstatements.”

C. The Supreme Court

The *Halliburton* plaintiff filed a petition for writ of *certiorari*, asking the Supreme Court to address what it called the Fifth Circuit's "substantial and unprecedented burden" on securities class action plaintiffs.¹⁷ The petition argued that the Fifth Circuit's holding is in direct conflict with principles adopted in other circuits and federal district courts, as well as the Supreme Court's holding in *Basic*, which adopted the fraud-on-the-market theory as a means for class members to establish reliance in securities cases.

Interestingly, the Supreme Court invited the United States Solicitor General to weigh in on the *certiorari* petition. The Solicitor General strongly supported the plaintiff in *Halliburton*, arguing that the Supreme Court should resolve a divide amongst the circuits on the issue of whether loss causation must be resolved at the class certification stage. The Solicitor General echoed the criticism of the Fifth Circuit's interpretation, including that it requires plaintiffs to prove a significant element of their case at the class certification stage, without the benefit of full discovery and without consideration of their claims by a jury. The Solicitor General posited that the only relevant question at the class certification stage with respect to loss causation is whether resolution of the loss causation issue can be expected to turn on proof that is common to class members generally. While he acknowledged the defendants' ability to rebut the fraud-on-the-market presumption, the Solicitor General argued that "so long as the market distortion inquiry turns on factual or legal issues that are common to the members of the putative class, class certification is appropriate regardless of the perceived likelihood at that early stage that the plaintiffs will be able to establish that element of their claims on the merits."¹⁸

Both the Solicitor General and petitioner were specifically concerned with the Fifth Circuit's requirement that a plaintiff must show that losses were more probably caused by corrective disclosure (related to the false, non-confirmatory positive statement made earlier) and not any other negative statements. This is a rigorous showing that generally requires both expert testimony and analytical research, or an event study that demonstrates the linkage between the culpable disclosure and the stock price movement. The Solicitor General also noted that by placing the burden on plaintiffs to disaggregate multiple negative statements, unscrupulous defendants have the opportunity to manipulate their disclosures to avoid shareholder claims.

The Supreme Court granted *certiorari* on January 7, 2011. Oral argument is scheduled for April 25, 2011.

V. CONCLUSION

In *Halliburton*, the Supreme Court once again will be asked to strike a balance between the competing policies underlying the federal securities laws: maintaining public confidence in the securities markets by deterring fraud and compensating aggrieved shareholders, while at the same time tempering antifraud measures to prevent vexatious litigation. In recent years, the court's decisions have tended to favor the defense bar. This case may go the other way, and if so, it would hardly be surprising. But if the Supreme Court adopts the Fifth Circuit's stringent approach to class certification, *Halliburton* will dramatically alter the landscape, and the Fifth Circuit's decisions in *Oscar*, *Belo*, and *Halliburton* may be a precursor of similar battles that will take place nationwide.

¹ John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and Its Implementation*, 106 COLUM. L. REV. 1534, 1539 (2006).

² *Tellabs Inc. v. Makor Issues & Rights*, 551 U.S. 308 (2007) (addressing standards for pleading scienter); *Stoneridge Investment Partners v. Scientific-Atlanta*, 552 U.S. 148 (2008) (addressing liability of secondary actors); *Morrison v. National Australia Bank*, 561 U.S. ____ (2010) (addressing extraterritorial jurisdiction); *Merck & Co., Inc. v. Reynolds*, 599 U.S. ____ (2010) (addressing statute of limitations).

³ *Matrixx Initiatives, Inc. v. Siracusano*, No. 09-1156; *Janus Capital Group, Inc. v. First Derivative Traders*, No. 09-525.

⁴ 125 S. Ct. 1627 (2005).

⁵ 640 F.2d 534, 549 (5th Cir. 1981), *rev'd on other grounds*, 459 U.S. 375 (1983).

⁶ The elements of a Rule 10b-5 action include: (1) a material misrepresentation or omission; (2) in connection with the purchase or sale of a security; (3) reliance; (4) scienter (i.e., a wrongful state of mind); (5) economic loss or damages; and (6) loss causation (i.e., a causal connection between the material misrepresentation and the plaintiff's losses).

⁷ *Basic Inc. v. Levinson*, 485 U.S. 224, 242-47 (1988).

⁸ *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336 (2006).

⁹ *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 262 (5th Cir. 2007).

¹⁰ 261 Fed. Appx. 697, 69 Fed. R. Serv. 3d 1238 (5th Cir. 2008).

¹¹ 572 F.3d 221 (5th Cir. 2009) (per curiam) (O'Connor, J., sitting by designation).

¹² 579 F.3d 401 (5th Cir. 2009).

¹³ Notably this approach is similar to that used by the Tenth Circuit in *In re Williams Sec. Ltiig.*, 558 F.3d 1130 (10th Cir. 2009).

¹⁴ No. 3:02-CV-1152-M, 2008 WL 4791492 (N.D. Tex. Nov. 4, 2008).

¹⁵ 618 F.3d 679 (7th Cir. 2010).

¹⁶ 544 F.3d 474 (2d Cir. 2008).

¹⁷ Pet. for Writ of Certiorari, *Halliburton* (No. 09-1403). The petition asks the Court to consider two questions: (i) whether the Fifth Circuit correctly held that plaintiffs in securities fraud actions must not only satisfy the requirements to trigger a rebuttable presumption of fraud on the market, but also establish loss causation at class certification by a preponderance of the admissible evidence without merits discovery; and (ii) whether the Fifth Circuit improperly considered the merits of the underlying litigation when it held that a plaintiff must establish loss causation to invoke the fraud-on-the-market presumption.

¹⁸ Brief for the United States as Amicus Curiae at 15, *Halliburton* (No. 09-1403).