Client Alert.

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U.S. Supreme Court Unanimously Rejects Fifth Circuit Rule Requiring Securities Fraud Plaintiffs to Prove "Loss Causation" in Order to Obtain Class Certification

By Joel C. Haims and Edward Blatnik

Yesterday, the U.S. Supreme Court unanimously rejected the Fifth Circuit's rule that securities fraud plaintiffs are required to prove "loss causation" (i.e., that the defendant's deceptive conduct caused their economic loss) to obtain class certification of their claim under Federal Rule of Civil Procedure 23. (*Erica P. John Fund, Inc. v. Halliburton Co.*) The Court agreed to hear the case to resolve a conflict between the Fifth Circuit's rule and the opposing view taken by the Second, Third, and Seventh Circuits that there is no such requirement.[1]

Lead plaintiff Erica P. John Fund, Inc., on behalf of a putative class of purchasers of Halliburton common stock between June 1999 and September 2001, alleged that Halliburton violated Section 10(b) of the Securities and Exchange Act of 1934 and SEC Rule 10b-5 by making various misrepresentations designed to inflate its stock price during that period.[2] The district court found that class plaintiffs met all of the standard requirements of Rule 23, but nonetheless denied their motion for class certification on the sole ground that they had failed to prove loss causation, as required by binding Fifth Circuit precedent.[3] Unsurprisingly, the Fifth Circuit affirmed.

Finding the Fifth Circuit's rule to be without basis, a unanimous Supreme Court vacated the Fifth Circuit's judgment and remanded. In his opinion for the Court, Chief Justice John Roberts diagnosed the Fifth Circuit's error as stemming from an apparent confusion between two of the six elements of a Rule 10b-5 claim: (i) reliance or "transaction causation" (the requirement that the defendant's misrepresentation caused the plaintiff to engage in the transaction in question) and (ii) loss causation (the requirement that the defendant's misrepresentation caused the plaintiff's economic loss).

In *Basic Inc., v. Levinson*, 485 U.S. 224 (1988), the Court established the "fraud-on-the market" presumption for proving transaction causation. Since Rule 23(b)(3)'s requirement that common questions of law and fact predominate is "often" met in a securities fraud action by showing transaction causation, securities fraud plaintiffs can meet that requirement by showing that the "fraud-on-the-market" presumption applies to their claim.[4] According to the Court, the Fifth Circuit erroneously read *Basic* to require plaintiffs "to establish loss causation at the certification stage to trigger the fraud-on-the-market presumption."[5] But this "loss causation" requirement is "not justified by *Basic* or its logic" and in fact "contravenes *Basic*'s fundamental premise—that an investor presumptively relies on a misrepresentation so long as it was reflected in

[1] Slip Op. at 3.

[2] Slip Op. at 1.

[3] Slip Op. at 2 (noting the district court's application of *Oscar Private Equity Invs. v. Allegiance Telecom, Inc.*, 487 F.3d 261, 269 (5th Cir. 2007)).

[4] Slip Op. at 6-7.

[5] Slip Op. at 6 (internal quotations and citation omitted).

the market price at the time of his transaction."[6] Loss causation, in contrast, focuses on the entirely different question of whether "a misrepresentation that affected the integrity of the market price *also* caused a subsequent market loss." Thus, a securities plaintiff's inability to prove loss causation "has no logical connection" to whether he can properly invoke the "fraud-on-the-market" presumption.

Because the Fifth Circuit was the only circuit court to have adopted the erroneous "loss causation" requirement for obtaining class certification, the Court's decision today will have little impact on securities fraud litigation throughout the nation.

Contact:

Joel C. Haims
(212) 468-8238
jhaims@mofo.com

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[6] Slip Op. at 6-7.