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Halliburton: The Morning After

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Editor's Note: Boris Feldman is a member of Wilson Sonsini Goodrich & Rosati, P.C. The views expressed in this post are those of Mr. Feldman and do not reflect those of his firm or clients. Doru Gavril also contributed to this post. The Supreme Court's expected reconsideration of *Basic* is also discussed in a Harvard Law School Discussion Paper by Professors Lucian Bebchuk and Allen Ferrell, Rethinking *Basic*, discussed on the Forum here.

The blogosphere is abuzz over *Halliburton*.[1] Will the Supreme Court overturn *Basic*[2] and abolish the fraud-on-the-market presumption? Will the decision end shareholder class actions as we have known them? Presumably, by the Fourth of July, we will know.

The purpose of this post is not to predict the outcome of *Halliburton*. Rather, it is to begin thinking about ways in which the plaintiffs' bar may respond if the Court does overturn *Basic*. Those who think that plaintiffs' lawyers will go quiet into the night are, in my opinion, ignoring the lessons of history.

A Track Record of Resilience

Over the past two decades, the business community has labored mightily to extirpate shareholder class actions. In court and in Congress, critics of shareholder suits have gone after litigation abuses aggressively and with some success. Yet while annual filing rates fluctuate, the fact is that securities class lawyers have survived and even thrived. Why?

A key factor is the persistence and resilience of those lawyers. In many areas of the law, plaintiffs' lawyers have demonstrated creativity and entrepreneurialism. In the field of shareholder litigation, they have shown exceptional resilience. Let's take a few examples.

[1] *Halliburton Co. v. Erica P. John Fund, Inc.*, No. 13-317. One of the questions on which cert was granted is: "Whether this Court should overrule or substantially modify the holding of Basic Inc. v. Levinson, to the extent that it recognizes a presumption of classwide reliance derived from the fraud-on-the market theory."

[2] *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).

The Private Securities Litigation Securities Reform Act of 1995[3] was virtually a bill of attainder against a discrete group of lawyers. The law enjoyed broad bipartisan support. It was the only law as to which Congress overrode a veto by President Clinton. Some defense lawyers began to attend classes on patent law, in anticipation of mid-career retooling.

How did the plaintiffs' bar react? It went to state court. Although some now forget, plaintiffs did pretty well in state court. For example, the California Supreme Court adopted broad, pro-shareholder interpretations of statutes and remedies that had lain on the books, unused, for decades.[4] After several years, this triggered a response from the business community in the form of Federal preemption.[5] Even then, the plaintiffs' bar managed to exclude from the statute derivative lawsuits and merger claims, which became lucrative growth areas for that bar.

A second example involves the stringent pleading standards imposed by the Reform Act. These standards represented a rare departure from "notice pleading." They raised the bar to a level many thought plaintiffs could not satisfy, particularly without benefit of discovery. Indeed, President Clinton cited as a reason for vetoing the law his concern that the elevated pleading standard would cause even "the most aggrieved investors with the most painful losses [to] get tossed out of court."[6] More bluntly, Senator Sarbanes suggested that the Reform Act's safe harbor for forward-looking statements created a "license to lie."[7]

Nevertheless, plaintiffs adapted. For years, they persuaded lower courts to apply less onerous pleading standards than the statute appeared to require. It took multiple Supreme Court decisions to articulate a uniform pleading standard and to underscore that the statute meant what it said.[8] Yet even then, the standard is applied by 700 separate district judges, who often take a more forgiving view of what constitutes "a strong inference" than one would have expected from the appellate precedents. It is not uncommon for a district court, after several rounds of dismissal with leave to amend, to conclude that the plaintiffs have alleged enough to get through the gate. The persistence, and pleading creativity, of the plaintiffs' bar have made the heightened pleading requirements less of a death knell than many expected at the time of enactment.

One could point to other examples. A principal feature of the Reform Act was the mandatory Rule 11 review at the end of a shareholder class action.[9] This is a statutory requirement that has

[3] Pub. L. 104-67, 109 Stat. 737 (1995).
[4] *Diamond Multimedia Systems, Inc. v. Superior Court*, 19 Cal. 4th 1036 (1999); *Stormedia Inc. vs. Superior Court*, 20 Cal. 4th 449 (1999).
[5] The Securities Litigation Uniform Standards Act of 1998, Pub. L. 105-353, 112 Stat. 3227 (1998).
[6] H.R. Doc. No. 104-150, reprinted in 141 Cong. Rec. H15215 (daily ed. Dec. 20, 1995) (veto message from the President of the United States).
[7] 141 Cong. Rec. S19041 (daily ed. Dec. 21, 1995) (exhibit 2 to statement of Senator Sarbanes).
[8] *See, e.g.*, *Matrixx Initiatives, Inc. v. Siracusano*, 131 S. Ct. 1309 (2011); *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 551 U.S. 308 (2007); *Dura Pharm, Inc. v. Broudo*, 544 U.S. 336 (2005).
[9] 15 U.S.C. 77z-1(c); 15 U.S.C. 78u-4(c).

largely been ignored by the courts, even when they throw out the lawsuits. The same is true of aiding-and-abetting liability. The Supreme Court made clear, back in 1994, that federal securities claims could not be based on secondary liability.[10] Yet time after time plaintiffs managed to persuade lower courts, especially in "dirty" cases, to allow claims to proceed against secondary actors. The Supreme Court has had to revisit this issue on numerous occasions, in Horton-like terms: "I meant what I said and I said what I meant."[11] But still the claims come, and some district judges strain to let them proceed.

I do not mean to suggest that the Reform Act, or SLUSA, or *Central Bank*, had no impact. They had great impact on many cases. But they did not put the plaintiffs' bar out of business. Nor did they eradicate strike suits. On the contrary, knee-jerk merger challenges and baseless derivative suits remain common and often remunerative.

If recent history is a guide, then, even a strong decision in *Halliburton* is unlikely to make the plaintiffs' bar give up. I suspect that plaintiffs will wage a multi-front war to survive even in the face of judicial abolition of the fraud-on-the-market presumption. Here are three fronts that we might expect.

Front One: Direct Attack

If *Halliburton* overturned *Basic*, Congress could overturn *Halliburton*. This is a statutory issue, not a constitutional one. As a technical matter, reversal would not be complex. The simplest approach would be to enshrine the *Basic* presumption in the '34 Act. Alternatively, Congress could simply say that it is overturning *Halliburton* and returning the law to what it was prior to that decision. In theory, Congress could articulate explicitly what rules govern pleading reliance in private actions under Section 10(b). But that risks getting bogged down in nuanced debates. Simpler just to reverse the decision legislatively and then let the courts deal with that.[12]

The issue, of course, is the votes. One may assume that the Administration, and the Senate, would be open to this action. The House, not so much. But even there, one should be cautious in assuming that the House would block a restoration of the fraud-on-the-market presumption. The financial press would characterize reversal of *Basic* as the abolition of private redress for securities fraud. Pension funds and mutual funds could generate substantial investor support for keeping alive classwide remedies for stock fraud. We live in a post-Enron, post-Madoff world.

[10] *Central Bank of Denver, NA v. First Interstate Bank of Denver, NA*, 511 U.S. 164 (1994).

[11] Dr. Seuss, Horton Hatches the Egg (Random House ed.) (1940).

[12] When the Supreme Court held in *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350 (1991), that the express cause of action provisions in the '33 Act supplied the appropriate limitations periods for claims under Section 10(b), Congress reversed it by statute. Federal Deposit Insurance Corporation Improvement Act of 1991, Pub. L. No. 102-242, 105 Stat. 2387, Title IV, Subtitle M, § 476 (codified as 15 U.S.C. § 78aa-1 (1991)).

Many Representatives, especially from districts without a large high-tech presence, might be unwilling to go against an army of small investors passionate on this issue. So, while I think legislative reversal would face an uphill battle in the House, there is no doubt that the plaintiffs' bar would give it a try.

Front Two: Sneak Attack

A second way that plaintiffs might respond to a loss in *Halliburton* is by trying to undermine it in the lower courts. Securities plaintiffs' lawyers are masters of the disingenuous pleading doctrine. They are skilled at using bad facts to influence judges' application of precedents unfavorable on their face.

How, precisely, plaintiffs will do that here depends on the specifics of the *Halliburton* ruling. For example, if the decision overturns *Basic* but leaves *Affiliated Ute*[13] alone, one can confidently predict that all cases will be pleaded as omissions cases instead of misstatement cases. A few years down the road, the Supreme Court (depending on personal changes) might respond by closing that loophole—but in the interim, plaintiffs would have survived many dismissal motions by recharacterizing their claims as "omissions."

Similarly, if the decision leaves any room at all for asserting reliance on the integrity of the market, then whatever parameters the Court sets are what the plaintiffs will allege in each case. All that plaintiffs need is to survive the motion to dismiss: in many instances, that will lead to a lucrative settlement. If the focus shifts to class certification, then plaintiffs will argue that classwide treatment is appropriate on issues of falsity, materiality, and scienter, leaving issues of reliance for post-trial "mini-trials" for each class member—a situation that will rarely occur.

Short of a broad ruling that says explicitly that class treatment of securities claims is not permitted because individual claims of eyeball-reliance always predominate, plaintiffs will find ways to plead within the decision and persuade some courts not to throw the suit out at the threshold.

It is worth noting that even a broad ruling will not wipe out *all* shareholder suits. For example, Section 11 of the '33 Act does not contain a reliance requirement.[14] Nor do derivative suits typically involve reliance issues. In merger cases based on breach of fiduciary duty, rather than disclosure issues, plaintiffs will argue that reliance is not an element of the claim.

[13] *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153-54 (1972) ("Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery.")

[14] Although reliance is generally not a requirement of Section 11, it is required for suits filed more than a year after the registration statement is issued. Even then, the statute does not require eyeball reliance. *See* 15 U.S.C. §77k(a) ("such reliance may be established without proof of the reading of the registration statement by such person").

Front Three: The SEC

Another front on which plaintiffs are likely to engage is administrative. Open-market (as opposed to IPO) shareholder class actions are generally brought pursuant to SEC Rule 10(b)5.[15] In the event of a loss in *Halliburton*, plaintiffs are likely to seek help from the Commission.

There are five potential ways in which the SEC might become involved. The most direct, but risky, would be for the SEC to overrule *Halliburton*: that is, to amend Rule 10(b)5 to include the fraud-on-the-market presumption as an explicit way to establish reliance in private actions.[16] The '34 Act itself, in Section 10(b), proscribes conduct in contravention of "such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."[17] The SEC might assert its right to adopt the presumption pursuant to that statutory authority, following a rulemaking proceeding. The risk of this approach, of course, is that it is a direct challenge to the Supreme Court. The Court could find that the same factors that led it to reject the presumption in *Halliburton* rendered the agency action invalid.

A second, more modest, approach would be to define circumstances in which the presumption is appropriate. This depends in large part on the contours of the *Halliburton* opinion. The second cert question asks: "whether, in a case where the plaintiff invokes the presumption of reliance to seek class certification, the defendant may rebut the presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock." If *Halliburton* declines to reject the fraud-on-the-market presumption universally, but instead cuts back on the automatic invocation of the presumption, this could give the SEC room to articulate factors that make the presumption appropriate in particular cases. If the Supreme Court has identified those factors, however, the Commission would be risking a finding of effrontery were it to deviate from those factors.

A third approach would be a simple disclosure requirement: companies must disclose in their SEC filings whether or not they trade in an efficient market. Companies would feel pressure to say "yes." Creative corporate lawyers would develop boilerplate language to respond without saying "yes" or "no," but those likely would trigger SEC comments. If a company represented that it did trade in an efficient market, some courts might hold that this was sufficient to justify a classwide presumption of reliance.

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[15] 17 C.F.R. 240.10b-5.

[16] For example, several courts had held that in pursuing insider-trading claims, the SEC had to prove that the defendant acted in reliance on the inside information, not just while in possession of it. The SEC adopted Rule 10b5-1 to overrule those decisions. *See* 17 C.F.R. § 240.10b5-1.

[17] 15 U.S.C. § 78j.

A fourth approach would focus on exchange-listing requirements. The SEC might require that, for a company to be eligible for listing on an exchange or the National Market System, it must certify that it is traded in an efficient market. This has some basis in the law already. For a company to invoke the preemption requirements of SLUSA, and be exempted from state Blue Sky laws, it come within that status.[18] The Commission might include this as an additional NMS requirement.

A fifth approach would be to amend other securities-law provisions that benefit issuers so that they are only available to companies that trade in efficient markets. For example, the SEC might provide that various safe-harbor provisions, or the simplified registration requirements available to WKSI's,[19] apply only if the stock is traded on an efficient market. Of course, the Commission would need to define what constituted an efficient market. But this could give plaintiffs' lawyers another hook at invoking a presumption of reliance with respect to such companies.

Whether such attempts to undo *Halliburton* by administrative fiat would prevail is uncertain. Although courts generally give deference to agency interpretations, the SEC's track record in imposing its views on the Supreme Court has been quite mixed.[20] Indeed, SEC promulgations in general have been vulnerable to administrative-law challenges in recent years.[21] Nevertheless, the business community needs to be on the alert to the fact that, having lost on 1st Street, the plaintiffs' bar may seek relief ten minutes away on F Street.[22]

Practical Implications

This is all conjecture until we see what the Court actually does in *Halliburton*. Notwithstanding the contours of the final ruling, and regardless of whether *Basic* is obliterated or simply refined, two observations are worth note. First, the business community needs to prepare for the plaintiffs' responses to the decision, be they before Congress or at the SEC. The plaintiffs' bar is well-organized and amply funded. Trust me, they are making their contingency plans now. Industry should not assume that, if it wins at the Supreme Court, the problem will go away. "Peace in our time" rarely is.

Second, individual companies would be making a serious mistake if, in the face of a reversal of *Basic*, they cut back their D&O insurance protection. The aftermath of *Halliburton* will play out in the courts for years. As I've speculated above, it may also play out on the Hill and in the

[18] *See* 15 U.S.C. § 78bb(f)(5)(E); 15 U.S.C. § 77r(b).

[19] 17 C.F.R. § 230.415.

[20] *See, e.g.*, *Stoneridge Inv. Partners v. Scientific-Atl.*, 552 U.S. 148 (2008); *Central Bank*, 511 U.S. 164; *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976).

[21] *See, e.g.*, *Bus. Roundtable v. Sec. and Exch. Comm'n*, 647 F. 3d 1144 (D.C. Cir. 2011) (invalidating Rule 14a-11, 75 Fed. Reg. 56,668 (2010)).

[22] from: Securities Exchange Commission, 100 F St NE, District of Columbia, 20549 to: Supreme Court of the United States, 1 First St NE, Washington, DC 20543

agencies. During that time, shareholder suits are likely to be even more expensive to litigate than now, because there will be novel legal issues to be fought over. Similarly, to the extent that the threat of shareholder suits has caused companies to adopt more conservative disclosure or trading practices, prudence suggests that those should not be eased or abandoned until the promise of *Halliburton* becomes a reality.