# Two professors'crusade for justice

By Alison Frankel

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For two months last summer, Stanford Law School professor Joseph Grundfest locked himself away in his home office in California's Portola Valley. Grundfest's house overlooks the Santa Cruz Mountains, but his attention was fixed on the piles of paper - mostly US Supreme Court opinions and Congressional reports from the 1930s - stacked on his desk and the surrounding floor.
Grundfest researched and wrote for weeks with monastic obsessiveness, speaking to hardly anyone but his research assistants and his wife, who made sure he was eating.

When he emerged in August, Grundfest - an influential former Commissioner at the US Securities and Exchange Commission who now sits on the board of the private equity firm KKR & Co - had in hand a 78-page paper larded with more than 400 footnotes.

His aim was nothing less than to destroy securities fraud class action lawsuits by shareholders, which have been the bane of many businesses in the US since the Supreme Court endorsed the cases 26 years ago.

Grundfest sent the draft around to several other law professors, including the University of Michigan's Adam Pritchard, another favorite of pro-business groups. Pritchard read Grundfest's paper with a sense of familiarity: Five years earlier, in a study for the Cato Institute, he had pinpointed the same obscure provision of a 1934 securities law as the means to curtail big settlements in securities fraud class actions. He sent Grundfest an email: "I see you've put a new twist on things."

The intellectual jousting match between Grundfest and Pritchard is no longer just academic. Any day now, in the case Halliburton Co v. Erica P John Fund, the Supreme Court will decide the future of securities fraud class actions, litigation that has generated more than $80 billion in settlements and untold billions more in legal fees.

Grundfest and Pritchard filed competing friend-of-the court briefs, both supporting Halliburton but advocating different rationales for curtailing shareholder cases.

The court may, of course, decide to make no change, but if the justices do rein in securities fraud litigation, it's widely expected that they will lean on arguments advanced by Pritchard or Grundfest. But which one?

## BEGINNING WITH 'BASIC'

The foundation of securities fraud class actions is a 1988 Supreme Court decision in the case Basic v. Levinson. It applied to fraud litigation a then-voguish economic theory, the efficient capital markets hypothesis, which posits that share prices reflect all publicly available information.

The court said that when a broadly-traded corporation publicly misrepresents the truth, it perpetrates a "fraud on the market" - so individual shareholders need not show that they relied on corporate misstatements.

The Basic ruling led to an explosion of shareholder class actions. The number of filings tripled between 1988 and 1991, according to Georgetown University law professor Donald Langevoort, prompting such an outcry from corporate defendants that Congress rewrote the rules for shareholder class actions twice in the 1990s.

Even after those reforms, the boom in securities fraud suits continued, resulting in six of the 10 biggest settlements in class action history.

Proponents of the cases argue that they return money to deceived shareholders and provide a necessary private complement to the SEC's regulatory enforcement. Detractors claim the suits don't actually benefit shareholders, just their lawyers.

For decades, pro-business groups such as the US Chamber of Commerce have railed against shareholder class actions, both in Congress and in briefs at the Supreme Court. But in 25 years of litigation challenges, corporate defendants managed only to restrain securities fraud class actions, not to eliminate them.

Basic v. Levinson seemed to be irreversible - until Justice Antonin Scalia suggested otherwise at oral arguments in November 2012 in Amgen v. Connecticut Retirement Plans. "Maybe we shouldn't have this fraud-on-the-market theory," Scalia said. "Maybe we should overrule Basic."

## TWO LINES OF ATTACK

Scalia's comment was apparently prompted by a friend-of-the-court brief submitted by Pritchard and two other law professors - the only brief in the Amgen case explicitly to call on the justices to reverse Basic.

Pritchard has been critiquing the Basic decision since he was a student editor at the Virginia Law Review in 1991. In his Cato paper, Pritchard pioneered a theory based on Justice Byron White's dissent in the Basic case. He focused on the one provision of the Securities Exchange Act of 1934 (the law governing securities fraud) that specifically addresses private shareholder suits.

That provision, Section 18, requires investors to prove they relied on corporate misrepresentations. Pritchard argued that Section 18 severely restricts the damages shareholders

can collect in fraud class actions.

Along with other law professors, Pritchard also questioned the economic underpinnings of "fraud on the market" doctrine, arguing that it's based on an overly simplistic view of share prices. Pritchard, Yale Law School professor Jonathan Macey and University of Chicago professor Todd Henderson first pitched that argument to the Supreme Court in a 2011 friend-of-the-court brief.

They proposed that investors should be required to show that corporate misrepresentations distorted share prices by offering evidence of a market correction when the truth was revealed. Such "price impact" studies usually are submitted in the late stage of a case, when investors show how much they were damaged, but the professors said trial judges should require them before allowing investors to sue as a class.

The following year, Pritchard and Henderson filed a similar brief in the Amgen case, another challenge to a shareholder class action. When the Supreme Court came out with its Amgen opinion in February 2013, four justices bought in.

"Recent evidence suggests that [the Basic decision] may rest on a faulty economic premise," wrote Justice Samuel Alito. "In light of this development, reconsideration of the Basic presumption may be appropriate."

**A SHOT AT HISTORY**

Those were the words that sent Grundfest into seclusion last summer, to put on paper an idea he'd been mulling for several years. The Supreme Court's invitation to revisit Basic was a chance to make business history - even if curtailing the cases would cost him the fees he occasionally earns as an expert for defendants.

Grundfest's thesis went even further than Pritchard's. In broad terms, his paper argued that Basic can't override the language of Section 18. Investors, he said, can't recover money damages at all without showing they relied on corporate misstatements.

In its details, Grundfest's approach offered features to win over the Supreme Court's conservatives. It was grounded in the text of the 1934 law, which is the preferred approach of Justices Scalia and Clarence Thomas.

It would allow the court to avoid an economic debate on the efficient capital markets hypothesis. And its most subtle advantage was that the Supreme Court wouldn't have to overturn Basic altogether, which would make it more palatable for a court traditionalist like Chief Justice John Roberts to support.

Grundfest was itching to test the theory in a live case. He asked one of the lawyers to whom he'd sent a draft, George Conway of Wachtell, Lipton, Rosen & Katz, whether Wachtell had any candidates. Conway, a corporate defense lawyer who has dabbled in conservative politics, said he'd be on the lookout.

Less than a month later, the perfect opportunity appeared: Halliburton petitioned the Supreme Court to review an appeals court's decision allowing shareholders to proceed with a class action over decade-old claims that the oil-services giant underestimated its asbestos liability.

Grundfest and Conway, who volunteered his time, honed the professor's 78-page paper into a brief urging the Supreme Court to take Halliburton's case. Grundfest, also working without pay on this project, jumped on the phone and the computer to rally support for his filing.

"It was a labour of love," said Conway in an email. Added Grundfest: "Totally pro bono, not a nickel from anywhere."

Grundfest ultimately recruited a dozen other professors and former SEC officials to sign the brief, which described the 1988 precedent as "the most powerful engine of civil liability ever established in American law." One of the few professors who declined Grundfest's invitation was Pritchard. He had his own ideas.

**RALLYING SUPPORT**

Last November, the court voted to hear Halliburton's appeal. The justices do not announce their votes or reasoning, so it's impossible to know whether the Grundfest brief influenced their decision. But it influenced Halliburton. After the justices agreed to take the case, Halliburton's lawyers at Baker Botts adopted the Section 18 argument and cited Grundfest's paper in the company's brief.

Grundfest made a new round of calls to law professors and former SEC officials to garner support for a brief reiterating support for Halliburton.

In addition, he and Conway urged a friend, a former lawyer for the Senate Banking Committee, to organize a brief arguing that Congress didn't mean to endorse Basic when it failed to overturn the ruling in reforming securities litigation.

Pritchard, meanwhile, revised the brief from the Amgen case to add his own Section 18 argument, then looked around for co-signers. Chicago's Henderson said he'd join, even though he'd also signed Grundfest's filing. No one else agreed to join the brief.

On the other side, a group of 18 law professors banded together in a friend-of-the-court brief arguing for the status quo. One of them was Georgetown's Langevoort, who said the Basic decision simply gives "the person who has been hurt the right to sue." He was unmoved by the briefs from Grundfest and Pritchard. "Nothing in defendants' arguments denies that there is substantial harm from companies' lies," he said.

**A GAME OF BINGO**

Grundfest and his wife flew to Washington, D.C., for the March 5 oral arguments in the Halliburton case. The night before the hearing, they had dinner with Conway and a couple of

other friends and speculated about the questions the court would ask.

"We should make Bingo cards!" Grundfest said. Later that night, he did. On plain white paper labeled "Halliburton Bingo," the squares included "Section 18(a)," "Justice White," and "Lerach," a reference to the former plaintiffs lawyer Bill Lerach, who was convicted of criminal conspiracy for his role in a kickback scheme, and whose tactics prompted Congress to reform private securities litigation.

Grundfest also included himself and Pritchard - in separate squares. The next morning, he handed the Bingo cards out to friends. Pritchard skipped the arguments and took his kids to Disney World.

**COMPROMISE SOLUTION**

Halliburton lawyer Aaron Streett led off the company's argument with an oblique reference to Section 18. But then, several minutes into his presentation, the argument took a turn.

Justice Anthony Kennedy asked, "Would you address briefly the position taken by the law professors, I call it the midway position, that says there should be an event study?"

Justice Kennedy and other justices kept coming back to "the law professors' position," meaning Pritchard and Henderson, not Grundfest. The price impact argument had stolen the court's attention.

David Boies, who represented the shareholders suing Halliburton, emphasized that price impact studies are complex, expensive and time-consuming. But a lawyer for the government, which argued in support of the shareholders, conceded that the consequence of requiring such studies would not be dramatic.

The buzz outside of the courtroom after oral argument was all about the brief that had inspired so much interest from the justices. A cluster of shareholder lawyers standing in the Supreme Court lobby expressed relief that the justices seemed inclined to compromise instead of erasing their business.

None would talk on the record, but one plaintiffs lawyer said that if the Halliburton decision ended up requiring shareholders to show market impact, "We can live with that." After the argument, Grundfest called Pritchard. "He said, 'good for you,'" Pritchard said.

Weeks later, as he waited for the Supreme Court's opinion, Pritchard declined to hazard a guess about the outcome, predicting only that Chief Justice Roberts will be the swing vote.

Grundfest, meanwhile, was still hoping his ideas will influence the court. He said he could envision a three-way split in which the three most liberal justices ruled to leave Basic untouched, the three most conservative voted to overturn it and the three in the middle opted to leave Basic intact and add a price-impact test.

That would mean a victory for Pritchard and corporate defendants-even if it's not all that Grundfest, Halliburton and the broader business lobby had hoped for.