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Class Certification In A Post-Halliburton II World

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For over 25 years, plaintiffs' ability to invoke a presumption of reliance on the integrity of the market has been the lynchpin for class certification of securities fraud class actions. The concept of defendants' misrepresentations causing a fraud-on-the-market that distorted prices was actually first coined nearly 50 years ago by Abe Pomerantz, the pioneer of shareholder rights litigation in Herbst v. Able, 47 F.R.D. 11,16 (S.D.N.Y. 1969).

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'The relevant impact of the misrepresentations was on the market. It was the artificially heightened market price, pure and simple, which operated on plaintiffs and other members of the class to induce conversion.' If plaintiffs can prevail in their fraud-on-the-market theory, this may be sufficient to sustain a recovery under Section 10(b) of the Securities Exchange Act.

A socialist at heart, Abe would have been appalled when academics, and then courts, linked FOM to the Efficient Market Hypothesis posited by Jerry Fama of the Chicago School of Economics and disciple of Milton Friedman. Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities, 38 Bus. Law. 1, 3 (1982); Basic v. Levinson 485 U.S. 224, 246 (1988).

Some commentators asserted that the marriage of FOM and EMH caused securities fraud class actions to explode. (See Roberta Romano, The Shareholder Suit: Litigation Without Foundation?, 7 J.L. Econ. & Org. 55, 56 (1991); Janet Cooper Alexander, Do the Merits Matter? A Study of Settlements in Securities Class Actions, 43 Stan. L. Rev. 497, 499-501 (1991).) This was mildly ironic (though questionable in its causal reasoning), given that the hitching of EMH to securities fraud class actions was aimed at rationalizing, if not restraining, recoverable damages.

"Unanimous" Halliburton II Decision

Nonetheless, it was with some trepidation that the plaintiffs' bar viewed the U.S. Supreme Court's interest in revisiting the FOM/EMH marriage. The threat of annulment loomed large, given the possibility that a strict textualist approach (such as that espoused by Justice Antonin Scalia in Morrison v. Australia National Bank) could result in jettisoning decades of jurisprudence, and effective adoption of

the rationale espoused by the late Justice Byron White's dissent in Basic (which had presciently questioned whether judges were sufficiently equipped to evaluate economic theory). After all, by 2014 the EMH was under assault by behavioral economists that insisted investors — and hence markets — were rarely rational or efficient, citing evidence of "irrational exuberance," "bubbles" and volatile "mood-like" swings of market prices. Nor were plaintiffs' counsel blind to the irony that the 2013 Nobel Award for Economics had been awarded to Jerry Fama for proposing EMH, and to Robert Schiller, for debunking it.

Thus, it was with a collective sigh of relief that the plaintiffs' bar read the Supreme Court's 9-0 ruling in Halliburton II re-endorsing the presumption of reliance where plaintiffs proved "market efficiency." The presumption, though, was tweaked. Now, not only could defendants rebut the presumption if the investor clearly relied on nonmarket-related information in making its purchase, but also if defendants could demonstrate that the despite the misrepresentations, the stock's price had not been "impacted" by defendants' misconduct.

Frankly, even Abe would not have been disappointed by this decision, given that this conception of FOM was close to his original conception thereof. Moreover, the decision clearly signaled a retreat from a rigidly orthodox view of efficient markets. The Supreme Court expressly rejected the "robust view of market efficiency" espoused by petitioners, endorsing instead the view that the presumption of reliance could be triggered by a showing that the stock traded in a "generally" efficient manner. As Chief Justice John Roberts observed, the question of a market's efficiency was not a yes/no "binary" question, but rather more a spectrum analysis:

The markets for some securities are more efficient that the markets for others, and even a single market can process different kinds of information more or less efficiently, depending on how widely the information is disseminated and how easily it is understood.

Basic recognized that market efficiency is a matter of degree.

The Supreme Court placed the burden of proving lack of impact squarely on the defendants. Arguably, this will require defendants to demonstrate a high level of statistical confidence (i.e., the same level imposed on plaintiffs) that the market was not "impacted" by any of the "events" (i.e., the misstatements or corrections thereof) since that is the same burden plaintiffs must meet to demonstrate "efficiency". Stated otherwise, so long as there is evidence of some impact, enough to preclude defendants' experts from opining with "statistical certainty" that there was no impact, plaintiffs should be able to thwart rebuttal efforts.

The Supreme Court also arguably settled the issue of whether index investors (i.e., those who invest in bundles of securities in an effort to imitate, but not beat, the market), can be deemed to have "relied on the market."

As we recently explained, Basic concluded only that, "'[I]t is reasonable to presume that most investors — knowing that they have little hope of outperforming the market in the long-run based solely on their analysis of publicly available information — will rely on the security's market price as an unbiased assessment of the security's value in light of all public information.'

Especially significant, the Supreme Court also opened the door to class certification even where plaintiffs are unable to demonstrate efficiency: “A misrepresentation can distort [the] market even in a generally inefficient market.” In so doing, the high court echoed a position pitched by academics that was cited in petitioners brief.

[I]f a company is trading in a market in which there are significant deviations from efficiency, but the evidence shows fraudulent distortion in the situation actually at issue in the litigation, our approach would result in classwide reliance.

Thus, FOM has now come full circle since Abe’s original insight, with price impact restored to the equation, though placed on defendants’ side. Nonetheless, this represents a win-win for plaintiffs, effectively providing two mechanisms by which to trigger a presumption of classwide reliance. Indeed, as discussed below, there are now solutions to many of the conundrums observed in Professor Donald Langevoort in his oft-cited "Basic at Twenty: Rethinking Fraud on the Market."

What’s Next?

Measuring General Efficiency/Impact: Event Studies and Rapidity of Responses

Shortly after Basic, academics advocated borrowing tools developed by econometricians to measure the “efficiency’ of the market for particular stocks. (See Macey, Miller, Mitchell and Netter, Lesson from Financial Economics: Materiality, Reliance and Extending the Reach of Basic v. Levinson, 77 Va. L. Rev. 1017 (Aug 1991).) In time, this developed into a cottage industry with experts battling over whether market prices reacted consistently to company specific information, particularly where that information was “new” or different from what was expected. According the academics, not only was the degree of the reaction important, but so too was its rapidity, since the classic efficient market model hypothesized that in a well-developed market, prices reacted so quickly that “value investors” and analysts could not could not beat the market.

Such studies clearly added costs to litigation. However, anyone who has conducted market price analyses for antitrust class actions will likely view securities market event studies as a bargain. Among other things, the number of variables are far less.

Post-Halliburton II, plaintiffs will seize upon the Supreme Court’s rejection of the “robust” efficiency model in favor of a more relaxed, “generally” efficient model. It bears repeating that the high court recognized that “a single market can process different kinds of information more or less efficiently, depending on how widely the information is disseminated and how easily it is understood” and that a value investor “implicitly relies on the fact that a stock’ market price will eventually reflect material information.”

This should help drive different outcomes than those such in Merck & Co. Sec. Lit. In that case, Merck buried in an S-1 filing that a major subsidiary had previously overstated revenues. This news went unnoticed by analysts and there was no contemporaneous stock price reaction. Several weeks later, a Wall Street Journal reporter identified and quantified the overstatement, resulting in an immediate and significant stock price decline. Nonetheless the Third Circuit held that such a delayed response would not be consistent with an efficient market.

This reasoning was recently echoed in Bricklayers v. Credit Suisse Sec., where the court held that a price reaction following an analyst's change of recommendation (based on analysis of previously issued information) was not consistent with the EMH:

Accordingly, once a misstatement or corrective disclosure is publicly known in an efficient market, courts will assume that the stock price reacts immediately, and any claim that an event moved the stock price when the event was not actually a new disclosure will necessarily fail.

Thus, post-Halliburton II, a statistically significant price reaction should be sufficient regardless of whether the reaction takes place following the initial announcement of the news, or sometime later when an analysis "spotlights" its adverse impact on the company's financial condition.

Price Maintenance/Confirmatory Lies

There should be little doubt that in advocating for consideration of "price impact" at the certification stage, defendants hoped to bury securities fraud class actions by focusing on the fact that stock prices often don't move in response to the initial disseminations of fraudulent statements. However, this misstates the issue — merely because a stock price doesn't move or react does not mean it has not been "distorted" by defendants' misconduct.

By way of example, assume that a company knows that analysts are expecting earnings of $1.10 per share. However, as the quarter closes, management identifies only $1 of reportable earnings per share. Nonetheless, through accounting machinations, the company reports $1.10 earnings per share, thereby meeting market expectations. In the absence of any earnings "surprise," the market price will likely remain the same and be "maintained" by the "confirmatory lie." As noted by Bebchuk & Farrell:

In such a situation, the confirmatory lie might prevent a stock price drop that would have occurred had the truth been told.

Further assume that this pattern of meeting market expectations by inflating earnings 10 percent to meet analyst expectations continues for the entire year, thus precluding any price movement in connection with reported earnings. However, at the end of the year, the auditors blow the whistle and the company is forced to admit that it overstated reported earnings by 10 percent. The market will likely react by a significant decline, often in excess of 10 percent. This decline clearly evidences the impact defendants' misconduct had upon the stock price all along. As Bebchuck and Farrell observed, the price reaction when the market "learned the truth about the misstatement — that is, at the time of a corrective disclosure ... could be relevant as to whether the misstatement at the time it was made resulted in fraudulent distortion (even if it was a confirmatory lie)."

Thus, experts will need to consider not only whether the price moved at the time of the original announcement, but the market expectations at the time. Moreover, so long as the price moves significantly at the time of the corrective disclosure, and the correction clearly relates to a series of prior statements, "impact" should be evident.

Confounding Events

No doubt defendant counsel have long been cognizant of the perils of corrective disclosure, and have actively counseled clients how best to buffer their impact by orchestrating “soft landings” of such adverse news. One tack is to bundle the disclosure of past misconduct (i.e., the need to restate historical results) with other news (e.g., lowered forecasts due to competitive changes) thereby complicating measurement of the imbedded distortion. Leakage is undoubtedly another tool. Professor Frank Partnoy has conducted a study of soft landings that have been submitted for publication in the Journal of Financial Economics

Regardless, economists’ toolboxes contain several devices for disentangling these “confounding” events, as discussed below.

Response Coefficients

One methodology for disaggregating the impact of bundled news items was proposed in Esther Bruegger & Fred Dunbar, "Estimating Financial Fraud Damages with Response Coefficients" 35 Jrl. of Corp. Law 11 (2009). (Dunbar was founder and president of NERA consulting.)

The authors cited studies regarding earnings response coefficients (i.e., mathematical factors that can account for the relationship of a restatement of earnings to the likely price response). Once the ERC factor for a particular stock has been computed, taking into account, for example, the size of the restatement, the historic volatility of the individual stock and historic reactions to similar restatements, the portion of a stock price reaction attributable to the restatement can be isolated from other confounding news.

Forward Casting

Another analytic tool is to reconstruct how much the stock price would have reacted had the truth been told rather than the confirmatory lie. Thus, going back to the 10 percent earnings inflation earlier, assume that the stock was trading at a price:earnings of 15. If the earnings were inflated to $1.10, the expected stock price would be $16.50. Had the company reported only $1.00 per share, the stock price would have likely have been $15.00 (assuming for the moment that there was no decline in the p/e ratio). Hence, the amount by which the stock traded above $15 (in this case $1.50) would be the measure of distortion at the time of the wrongdoing.

Thus, upon announcement of the misstatement, it would be reasonable to expect that at least $1.50, or 10 percent, of the decline could be attributed to the original misconduct. Any additional decline beyond $1.50 could be attributed to other factors, though plaintiffs will likely argue that such additional decline is due to reassessment of the integrity of management. (See AUSA Life Ins. Co. v. Ernst & Young, finding that had the truth been told the plaintiffs would have realized management’s lack of credibility so that consequences of the dishonesty are within the zone of proximate cause.)

Content Analysis

A third means of disaggregating factors contributing to the price decline following a corrective disclosure is to identify key words in the company’s press release and analyst reports related to the fraud and to other subjects, and to apportion the price decline consistent with the ratio by which those terms appear. (See Frederick C. Dunbar & Arun Sen, Counterfactual Keys to Causation and Damages in Shareholder Class-Action Lawsuits , 2009 Wisc. L. Rev. 199, 242 Making Assessments About Materiality Less Subjective Through the Use of Content Analysis 1 (2007), available at http://

www.nera.com/image/PUB_Tabak_Content_Analysis_SEC1646-FINAL.pdf); NAACP v. AcuSport, Inc., 271 F. Supp. 2d 435, 515 (E.D.N.Y. 2003).)

Conclusion: New Math and 'Unanimous Decision'

Thus, the landscape for securities fraud class actions has been altered, though there is an element of deja vu all over again, with the addition of price impact to the analysis. The decision will certainly keep testifying experts busy for the foreseeable future and keep practitioners and judges scratching their heads as they attempt to fathom the mind-numbing data.

Lawyers will also undoubtedly argue over the Halliburton II 9-0 final score. Justice Clarence Thomas' "concurrence" was more akin to the Justice White's dissent in Basic. If Yogi Berra were a lawyer, he might insist that, like Roger Maris' home run record, this vote be recorded with an asterisk."

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