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## The Road Map For Class Certification Post- *Halliburton II*

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# The Road Map For Class Certification Post-*Halliburton II*

Marc I. Gross\*

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## BACKGROUND TO *HALLIBURTON II*

For over twenty-five years, defrauded investors’ ability to invoke a presumption of reliance on the integrity of the market has been the linchpin for class certification of securities fraud class actions. The concept that defendants’ misrepresentations create a “fraud on the market” (“FOM”) was first coined nearly fifty years ago by Abe Pomerantz, the pioneer of shareholder rights litigation, in *Herbst v. Able*.<sup>1</sup>

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1. 47 F.R.D. 11, 16 (S.D.N.Y. 1969). Origination of “fraud on the market” by Abe Pomerantz

“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 . . . .<sup>2</sup>

Courts struggling to fashion a tool for class-wide proof of reliance thereafter embraced the FOM concept.<sup>3</sup>

A socialist at heart, Abe would have been appalled when academics, and then courts, linked FOM to the “Efficient Market Hypothesis” (“EMH”) posited by Eugene Fama of the Chicago School of Economics and disciple of Milton Friedman.<sup>4</sup> Daniel Fischel first proposed the FOM/EMH marriage, just before joining the University of Chicago School of Law: “In an efficient capital market, such as American stock markets, however, the market price of a firm’s stock will reflect all available information about the firm’s prospects. Because the market price itself transmits all available information, investors have no incentive to study other available data.”<sup>5</sup>

The Supreme Court thereafter consecrated FOM/EMH in *Basic, Inc. v. Levinson*: “Recent empirical studies have tended to confirm Congress’ premise that the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations.”<sup>6</sup>

As Professor Donald Langevoort observed, *Basic*’s recognition of a

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was confirmed by Professor Jill Fisch in *The Trouble with Basic: Price Distortion After Halliburton*, 90 WASH. U. L. REV. 895, 907 (2013).

2. *Herbst*, 47 F.R.D. at 16 (citations omitted).

3. In 1975, Judge Koelsch of the Ninth Circuit stated:

Proof of subjective reliance on particular misrepresentations is unnecessary to establish a 10b-5 claim for a deception inflating the price of stock traded in the open market. Proof of reliance is adduced to demonstrate the causal connection between the defendant’s wrongdoing and the plaintiff’s loss. We think causation is adequately established in the impersonal stock exchange context by proof of purchase and of the materiality of misrepresentations, without direct proof of reliance. Materiality circumstantially establishes the reliance of some market traders and hence the inflation in the stock price—when the purchase is made the causal chain between defendant’s conduct and plaintiff’s loss is sufficiently established to make out a prima facie case.

*Blackie v. Barrack*, 524 F.2d 891, 906 (9th Cir. 1975) (citations omitted).

4. See Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383, 384 (1970) (linking the “fraud on the market” theory to the “efficient market hypothesis”).

5. Daniel R. Fischel, *Use of Modern Finance Theory in Securities Fraud Cases Involving Actively Traded Securities*, 38 BUS. LAW. 1, 4 (1982) (footnote omitted).

6. *Basic, Inc. v. Levinson*, 485 U.S. 224, 246 (1988). Fischel’s article was cited in support of this observation at 485 U.S. at 246 n.24.

class-wide presumption of reliance, based on proof of a well developed, rapidly reactive market, was an act of “juristic grace.”<sup>7</sup> But the grant was not unanimous. Justice White’s dissent reads like a “juristic curse,” which we will see haunted FOM/EMH from its inception:

The federal courts have proved adept at developing an evolving jurisprudence of Rule 10b-5 in such a manner. But with no staff economists, no experts schooled in the “efficient-capital-market hypothesis,” no ability to test the validity of empirical market studies, we are not well equipped to embrace novel constructions of a statute based on contemporary microeconomic theory.<sup>8</sup>

Thereafter, some commentators asserted that the FOM/EMH marriage enabled securities fraud class actions to proliferate.<sup>9</sup> This was mildly ironic (though highly questionable), given that hitching EMH to securities fraud class actions was aimed at rationalizing, if not restraining, recoverable damages.<sup>10</sup>

In response to the increased number of securities class actions, Congress sought to reign them in by way of the Private Securities Litigation Reform Act (“PSLRA”), Class Action Fairness Act (“CAFA”), and Securities Litigation Uniform Standards Act (“SLUSA”). Nonetheless, as incidents of fraudulent misconduct exponentially increased, so too did securities fraud class actions.<sup>11</sup>

“Reform” efforts thereafter shifted from Congress to the courts, as the Supreme Court raised the bar for pleading misleading statements<sup>12</sup>

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7. Donald C. Langevoort, *Basic at Twenty: Rethinking Fraud on the Market*, 2009 WIS. L. REV. 151, 161.

8. *Basic*, 485 U.S. at 253 (1988) (White, J., dissenting) (footnote omitted).

9. See Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 STAN. L. REV. 497, 499–501 (1991) (arguing that settlements in securities fraud class actions are neither voluntary nor accurate through studying a group of securities class actions involving similar claims of fraud in initial public offerings); Roberta Romano, *The Shareholder Suit: Litigation Without Foundation?*, 7 J.L. ECON. & ORG. 55, 56 (1991) (assessing the effectiveness of shareholder litigation as an incentive-alignment device by examining lawsuits brought against a randomly selected sample of publicly traded firms over several decades).

10. See Fischel, *supra* note 5, at 2 (stating that “fraud on the market” cases form the basis for rejection of the traditional method of determining injury and damages in open-market trading cases in favor of a more realistic economic approach).

11. See, e.g., *In re Worldcom, Inc. Sec. Litig.*, 219 F.R.D. 267 (S.D.N.Y. 2003); *In re Enron Corp. Sec., Derivative & ERISA Litig.*, 258 F. Supp. 2d 576 (S.D. Tex. 2003). These cases involved massive accounting frauds that resulted in multi-billion dollar settlements for the benefit of defrauded investors. The size of the frauds prompted adoption of the Sarbanes-Oxley Act, which increased corporate accountability by requiring, among other things, that senior officers certify not only reported results, but also the adequacy of internal financial controls.

12. See *Ashcroft v. Iqbal*, 556 U.S. 662, 678 (2009) (holding that the “plausibility” standard, for a complaint to survive a motion to dismiss for failure to satisfy the short-and-plain-statement requirement, is not akin to probability requirement, but asks for more than sheer possibility that the defendant acted unlawfully).

and loss causation.<sup>13</sup> However, securities fraud class action procedures remained relatively unscathed as the Court deferred the determination of loss causation and materiality from class certification to summary judgment.<sup>14</sup>

### I. THE “UNANIMOUS” *HALLIBURTON II* DECISION

Nonetheless, it was with great trepidation that the class action bar viewed the Supreme Court’s interest in revisiting the FOM/EMH marriage when it granted certiorari for *Halliburton Co. v. Erica P. John Fund, Inc.* (“*Halliburton II*”) in late 2013. The threat of an annulment loomed large, given the possibility that a strict textualist approach (such as that espoused by Justice Scalia in *Morrison v. Australia National Bank Ltd.*<sup>15</sup>) could reopen the genie bottle and give the current, more conservative court the chance to adopt Justice White’s dissent in *Basic*. The concerns were heightened by the fact that the EMH was now under assault not just by jurists, but also by behavioral economists who insisted that investors, and hence markets, were rarely rational or efficient. These experts cited “irrational exuberance,” “bubbles,” and volatile “mood like” swings of market prices. It was clearly ironic that the 2013 Nobel Award for Economics had been awarded to Eugene Fama for proposing EMH, as well as to Robert Schiller, for debunking EMH.

Thus, it was with a collective sigh that the plaintiffs’ bar read the Court’s 9–0 decision in *Halliburton II*,<sup>16</sup> which re-endorsed the presumption of reliance where plaintiffs proved “market efficiency.”<sup>17</sup> Plaintiffs could continue to trigger the presumption of reliance by

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13. See *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 341 (2005) (holding that an investor claiming securities fraud cannot satisfy the requirement of proving that the fraud caused an economic loss simply by alleging in the complaint, and subsequently establishing, that the price of the security on the date of purchase was inflated because of misrepresentation).

14. See *Amgen Inc. v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1191 (2013) (determining that materiality of a corporation’s alleged misrepresentations and omissions was a question common to all members of a class in a securities fraud action brought on a fraud-on-the-market theory, as materiality was judged according to an objective standard, and alleged misrepresentations and omissions would be equal for all investors composing the class); *Erica P. John Fund, Inc. v. Halliburton Co. (Halliburton I)*, 131 S. Ct. 2179, 2168 (2011) (holding that the court of appeals erred by requiring Erica P. John Fund, Inc. to show loss causation as a condition of obtaining class certification).

15. See *Morrison v. Nat’l Austl. Bank Ltd.*, 561 U.S. 247, 261–62 (2010) (holding that in terms of the scope of conduct prohibited by Rule 10b–5 and section 10(b), the text of the statute controls).

16. 573 U.S. —, 134 S. Ct. 2398 (2014).

17. See *id.* at 2410 (reaffirming that *Basic*’s presumption of reliance does not rest on a binary view of market efficiency, but instead that *Basic* recognized that market efficiency is a matter of degree).

demonstrating that the market for the company's securities was sufficiently robust (as indicated by, e.g., volume of trading, the number of market makers, and the number of analysts who followed the stock), as well as by demonstrating that the securities reacted rapidly and in a statistically significant amount to "new" company-specific news<sup>18</sup> (through the use of "event studies").<sup>19</sup>

Defendants could continue to rebut the presumption by demonstrating that a particular investor in fact did not "rely upon the market," but rather had access to non-public information or otherwise utilized an investment strategy that ignored the market entirely. However, this license to rebut reliance had proved to be pyrrhic. The Supreme Court, therefore, recalibrated the formula for rebuttal, enabling defendants to demonstrate that despite the misrepresentations, the stock's price had not been "impacted" by the alleged misconduct.<sup>20</sup>

Frankly, Abe would not have been disappointed by this decision. This approach more closely linked fraud with price movement. Moreover, the decision clearly signaled a retreat from a rigidly orthodox view of efficient markets. The Court expressly rejected the "robust view of market efficiency" espoused by the petitioners,<sup>21</sup> and instead endorsed 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 Roberts observed, the question of a market's efficiency was not a yes or no "binary" question, but rather more a spectrum analysis:

The markets for some securities are more efficient than 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 . . . .<sup>22</sup>

The Court also placed the burden of proving lack of price impact squarely on the defendants.<sup>23</sup> Arguably, this will require defendants to

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18. *Lax v. First Merchs. Acceptance Corp.*, 170 No. 97 C 2715, 1997 U.S. Dist. LEXIS 11866, at \*7–8 (N.D. Ill. Aug. 6, 1997).

19. Jonathan R Macey et al., *Lessons from Financial Economics: Materiality, Reliance, and Extending the Reach of Basic v. Levinson*, 77 VA. L. REV. 1017, 1018 (1991) (using event studies to determine whether false information caused a security to trade at an artificially high or low price).

20. See *Halliburton II*, 134 S. Ct. at 2417 ("[D]efendants must be afforded an opportunity before class certification to defeat the presumption through evidence that an alleged misrepresentation did not actually affect the market price of the stock.").

21. *Id.* at 2409.

22. *Id.* at 2409–10.

23. See *id.* at 2417 ("Defendants may seek to defeat the *Basic* presumption at [the certification] stage through direct as well as indirect price impact evidence.").

demonstrate at a ninety-five percent level of confidence that the market was *not* “impacted” by either of any of the “events,” i.e., the misstatements or corrections thereof, because 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 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 “it 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.”<sup>24</sup>

Especially significant, the Court also opened the door to class certification *even where plaintiffs are unable to demonstrate efficiency*: “A misrepresentation can distort a stock market’s price even in a generally inefficient market . . . .”<sup>25</sup> In so doing, the Court echoed a position pitched by academics that was cited in page thirty-nine of the Petitioners Brief: “if 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.”<sup>26</sup>

Thus, “fraud on the market” has now come full circle since Abe’s original insight, with price impact now restored to the formula to satisfy class-wide reliance by demonstrating that ‘defendants’ deceptive statements distorted the price of the stock in question, though now defendants would need to demonstrate the absence of such distortion.

## II. WHAT’S NEXT

Upon closer examination, there are now solutions to many of the conundrums observed by Professor Donald Langevoort in his oft-cited “*Basic at Twenty: Rethinking Fraud on the Market*,” e.g., delays in the

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24. *Id.* at 2411 (citing *Amgen v. Conn. Ret. Plans & Trust Funds*, 133 S. Ct. 1184, 1192 (2013)).

25. *Id.* at 2409.

26. Lucian A. Bebchuk & Allen Ferrell, *Rethinking Basic*, 69 BUS. LAW. 671, 690 (2014); see Brief for Petitioners at 39, *Halliburton Co. v. Erica P. John Fund, Inc. (Halliburton II)*, 134 S. Ct. 2398 (2014) (No. 13-317) (citing the Bebchuk & Ferrell study for posing a price-distortion test and providing examples of price distortion in inefficient markets).

stock's reaction to new corporate specific information despite the fact that the securities were listed on "efficient markets" such as the New York Stock Exchange.<sup>27</sup>

A. *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.<sup>28</sup> In time, a cadre of experts emerged to battle at the class motion stage over whether market prices reacted sufficiently, if at all, to company-specific information, particularly where that information was "new" or different from what was expected. According to the academics, not only was the degree of the reaction important, but so too was its rapidity, because the classic EMH model hypothesized that in a well-developed market, prices reacted so quickly that "value investors" and analysts 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 is far less.

Post-*Halliburton II*, plaintiffs will seize upon the Court's rejection of the "robust" efficiency model in favor of a more relaxed "generally" efficient model. It bears repeating that the 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's market price will *eventually* reflect material information . . . ."<sup>29</sup>

This observation should help drive different outcomes than those like *In re Merck & Co., Inc. Securities Litigation*,<sup>30</sup> where the company was buried in an S-1 filing stating that a major subsidiary had previously overstated revenues. This news went unnoticed by analysts, and there was no contemporaneous stock price reaction.<sup>31</sup> Several weeks later, a *Wall Street Journal* reporter identified and quantified the overstatement,

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27. See Langevoort, *supra* note 7, at 161.

28. See Macey et al., *supra* note 19, at 1028–35 (describing the methods to measure how much a stock price reacts to news).

29. *Halliburton II*, 134 S. Ct. at 2409, 2411 (emphasis added).

30. 432 F.3d 261 (3d Cir. 2005).

31. See *id.* at 264 (discussing the factual background that led to the claims that Merck & Co. had committed securities fraud and made material misstatements or omissions in the registration of statements).

resulting in an immediate and significant stock price decline.<sup>32</sup> Nonetheless, the Third Circuit held that such a delayed response would not be consistent with an efficient market.<sup>33</sup>

This reasoning was recently echoed in *Bricklayers & Trowel Trades International Pension Fund v. Credit Suisse Securities (USA) LLC*,<sup>34</sup> where the First Circuit 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."<sup>35</sup>

Post *Halliburton II*, a statistically significant price reaction should be sufficient regardless of whether the reaction followed the initial announcement of the news or occurred sometime later when an analysis turned the "spotlight" on the company's financial condition.

#### B. 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 because stock prices often do not move in response to the initial dissemination of fraudulent statements. However, this misstates the issue—merely because a stock price does not move or react does not mean that 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 \$1.00 of reportable earnings. 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 and Ferrell, "[i]n such a situation, the confirmatory lie might prevent a stock price drop that would have occurred had the truth been told."<sup>36</sup>

Further, assume that this pattern of meeting market expectations by

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32. See *id.* at 265 (stating that immediately after the *Wall Street Journal* article, Merck's stock lost \$2.22 billion and that six days later Merck announced it was postponing the Medco IPO).

33. See *id.* at 269–71 (discussing the facts of the case and the relation to "the efficient market").

34. 752 F.3d 82 (1st Cir. 2014).

35. *Id.* at 89 (footnote omitted).

36. Bebchuk & Ferrell, *supra* note 26, at 692.

inflating earnings ten 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 ten percent. The market will likely react by a significant decline, often in excess of ten percent. This decline clearly evidences the impact defendants' misconduct had upon the stock price all along. As Bebchuk and Ferrell 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 to the question of whether the misstatement at the time it was made resulted in fraudulent distortion (even if it was a confirmatory lie)."<sup>37</sup>

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.<sup>38</sup>

The confirmatory lie and price maintenance issue was recently addressed by the Eleventh Circuit in *Local 703, I.B. of T. Grocery & Food Employees Welfare Fund v. Regions Financial Corp.*<sup>39</sup> The plaintiffs asserted that the defendants' false statements simply confirmed the market's existing expectations about the company, thereby artificially maintaining the price of the stock.<sup>40</sup> As a result, none of the alleged misleading statements were accompanied by stock price increases.<sup>41</sup> The lone significant stock price change occurred following revelation of the fraud at the end of the class period.<sup>42</sup>

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37. *Id.*

38. Defendants will undoubtedly argue that merely because a company announces that it must restate earnings for three years does not mean the price was distorted by the same amount for the entire three years. However, this is more an issue of measuring damages that trigger a presumption of reliance. For instance, in *In re BP P.L.C. Sec. Litig.*, No. 4:10-md-2185, 2014 WL 2112823, at \*12 (S.D. Tex. May 20, 2014), the court denied class certification for investors who purchased BP shares prior to the Deepwater Horizon explosion on grounds that they could not credibly argue that the degree to which BP's stock price had been distorted by misrepresentation of its safety record was equivalent to the price drop when the explosion occurred. The court reasoned that "manifestation" of the previously concealed degree of the safety risk triggered a much larger price reaction than full disclosure of that risk would have. *Id.*; see David Tabak, *Risk Disclosures and Damages Measurement in Securities Fraud Cases*, 21 SEC. REFORM ACT LITIG. REP. 6 (2006) (examining some of the issues relevant to determining the amount of artificial inflation in a stock price when the possible disclosure was only of a risk of an event that was later realized).

39. 762 F.3d 1248 (11th Cir. 2014).

40. *Id.* at 1252.

41. *Id.*

42. *Id.*

Addressing market efficiency, the Eleventh Circuit refused to adopt any “mandatory analytical framework for market efficiency inquiries.”<sup>43</sup> In language reminiscent of *Halliburton II*'s rejection of a “robust” view of market efficiency, the court explained that “[e]ven . . . general signs of an efficient market may not be required for a finding of an efficient market in every case. Stocks that trade on a smaller scale, or that are not widely followed, might trade on an efficient market.”<sup>44</sup>

The court expressly rejected the defendant’s argument “that a finding of market efficiency always requires proof that the alleged misrepresentations had an immediate effect on the stock price.”<sup>45</sup> It observed that the lack of stock price movements in response to confirmatory misrepresentations was completely consistent with an efficient market,<sup>46</sup> and that a single decline following the corrective disclosure could be sufficient.<sup>47</sup>

### C. Confounding Events

No doubt defendants’ counsels 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 (the need to restate historical results) with other news (lowered forecasts due to competitive changes), thereby complicating measurement of the imbedded distortion. Leakage is undoubtedly another tool. (Michael Furchtgott and Frank Partnoy have conducted a study of soft landings.<sup>48</sup>)

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

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43. *Id.* at 1255.

44. *Id.*

45. *Id.* at 1256.

46. *Id.*

47. The Court remanded the case to enable defendants to rebut impact. *Id.* at 1259. The decision represents an “about-face” for the Eleventh Circuit, which had previously expressed an extremely rigid view of market efficiency. For example, in 2013, in *Meyer v. Greene*, 710 F.3d 1189, 1199 (11th Cir. 2013), the Eleventh Circuit affirmed dismissal of a complaint for failure to adequately plead loss causation, holding that an analyst’s new examination of previously disclosed facts could never be a corrective disclosure, noting that “[e]ither the market is efficient or it is not.” This prior view of market efficiency cannot be reconciled with *Halliburton II*'s proclamation that “*Basic*’s presumption of reliance . . . does not rest on a ‘binary’ view of market efficiency.” 573 U.S. —, 134 S. Ct. 2398, 2410 (2014).

48. Michael Furchtgott & Frank Partnoy, Disclosure Strategies and Shareholder Litigation Risk: Evidence from Restatements (May 13, 2012) (unpublished manuscript), available at [http://extranet.isnie.org/uploads/isnie2012/furchtgott\\_partnoy.pdf](http://extranet.isnie.org/uploads/isnie2012/furchtgott_partnoy.pdf).

#### D. “Response Coefficients”

One methodology for disaggregating the impact of bundled news items was proposed by Esther Bruegger and Fred Dunbar.<sup>49</sup> The authors cited studies regarding “earnings response coefficients” (“ERC”), i.e., mathematical factors that can account for the relationship of a restatement of earnings to the likely price response.<sup>50</sup> Once the ERC factor has been computed, the portion of a stock price reaction attributable to the restatement can be isolated from other confounding news.<sup>51</sup>

The authors gave an example of a situation where, during the subprime mortgage meltdown, a company confidently asserted in mid-March 2008 that its mortgage portfolio was fine, only to turn around two weeks later and announce that a significant writedown was in fact necessary. The authors further hypothesized that simultaneous with announcement of the need to writedown the mortgage portfolio, the Company also disclosed an earnings shortfall for the prior year ended December 31, 2007 that totaled \$1.50 per share (which presumably was due to factors unrelated to the portfolio writedown). In response to this disclosure of new “confounding” information, some of which was arguably fraud related (the belated portfolio writedown) and some of which arguably non-fraud related (the earnings shortfall for the prior year results), the stock price dropped \$10 per share.<sup>52</sup>

The problem presented to a financial market expert was how to separate the impact of the two sources of information, and assign a portion of the \$10 decline to each. The solution proposed by Bruegger and Dunbar was as follows:

[T]he event study on March 30, 2008 does not by itself allow one to determine the price decline exclusively due to the disclosure of the misrepresentation.

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49. See Esther Bruegger & Frederick C. Dunbar, *Estimating Financial Fraud Damages with Response Coefficients*, 35 J. CORP. L. 11, 12 (2009) (showing how “statistical analysis of the response of both share prices and investor expectations to new information can be used to improve the estimation of damages in shareholder litigation”).

50. See, e.g., *id.* at 31 n.65 (citing Ray Ball & S. P. Kothari, *Security Returns Around Earnings Announcements*, 66 ACCT. REV. 718 (1991)); *id.* at 33 n.74 (citing Robert L. Hagerman, Mark E. Zmijewski & Pravin Shah, *The Association Between the Magnitude of Quarterly Earnings Forecast Errors and Risk-Adjusted Stock Returns*, 22 J. ACCT. RES. 526 (1984)); *id.* at 33 n.76 (citing Walter R. Teets & Charles R. Wasley, *Estimating Earnings Response Coefficients: Pooled Versus Firm-Specific Models*, 21 J. ACCT. & ECON. 279 (1996)).

51. See *id.* at 35–36 (using ERCs to calculate price reactions).

52. See *id.* at 35 (demonstrating the application of response coefficients in a simplified situation).

Instead we can make use of the academic research on price reactions in response to earnings announcements, which provides us with a technique to calculate the price reaction due to the \$1.50 earnings disappointment. The technique uses the concept of an earnings response coefficient, or ERC . . . .

Let us assume that either through a regression analysis or from the professional literature, we can infer that [the Company] has an ERC of 5[x] over the relevant time period. This implies that for every cent of an earnings surprise its stock reacts by five cents.<sup>53</sup>

Under this methodology, \$7.50 of the \$10 price drop would be attributable to the earnings surprise ( $\$1.50 \times 5$ ) and the balance of the decline, and the remaining \$2.50 would be attributable to the subprime writedown.

### *E. Forward-Casting*

Another analytic tool is to construct the “counterfactual” of how much the stock price would have reacted had the truth been told rather than the confirmatory lie. Thus, going back to the ten percent earnings inflation above, assume that the stock was trading at a price/earnings ratio of 15x. 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 likely have been \$15.00 (assuming for the moment that there was no decline in the “price earnings” ratio).<sup>54</sup> 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 ten 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.”<sup>55</sup>

### *F. Content Analysis*

A third means of disaggregating factors that contributed to the price decline is to identify key words in the company’s press release and analyst reports relating to the fraud and to other subjects, and to

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53. *Id.*

54. The price earnings ratio is the multiple of reported earnings at which a stock trades, e.g., if the company reported \$1 per share earnings and traded at \$10 per share, its “p/e” ratio would be 10x.

55. *See infra* Part II.H.

apportion the price decline consistent with the ratio by which those terms appear.<sup>56</sup> This content methodology was endorsed in *N.A.A.C.P. v. AcuSport, Inc.*<sup>57</sup>:

[An expert's] opinions were largely based on a study that he performed using "content analysis." [The expert] and several of his research assistants reviewed documents and deposition testimony from the various defendants in an attempt to draw inferences as to which defendants did or did not employ any one of 14 "countermarketing" strategies [the expert] had identified. The results of this analysis were presented to the jury on charts that were useful and reliable in supporting his conclusions.<sup>58</sup>

### G. "Intent to Induce" Reliance

When faced with confounding information, plaintiffs should also demand discovery of investor-relations personnel to demonstrate that the confounding was deliberately orchestrated to thwart demonstration of price impact. For instance, a company may have uncovered the need to restate prior earnings, but waited to disclose that fact until it could also report the loss of a future contract that would have required lowered forecasts as well.<sup>59</sup>

This approach would be consistent with proof under the common law of "intent to induce reliance" (which is different from "intent to deceive" or scienter). It is the one element of the common-law tort of fraudulent misrepresentation that has not been incorporated into the federal securities laws.<sup>60</sup> The common law required proof that a company had a "reason to expect" investors would act in reliance on its

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56. See Frederick C. Dunbar & Arun Sen, *Counterfactual Keys to Causation and Damages in Shareholder Class-Action Lawsuits*, 2009 WIS. L. REV. 199, 242 ("When available, the most telling information is often contained in analyst reports following the disclosure."); David Tabak, *Making Assessments About Materiality Less Subjective Through the Use of Content Analysis* 11 (NERA, Mar. 13, 2007), available at <http://www.nera.com/publications/archive/2007/making-assessments-about-materiality-less-subjective-through-the.html> (discussing how analyst report headlines are examined).

57. 271 F. Supp. 2d 435 (E.D.N.Y. 2003).

58. *Id.* at 515.

59. A scenario similar to this played out years ago involving a company that was sued by our firm for securities fraud. The company internally identified side contracts that effectively converted sales into consignments, but did not make a disclosure (it claimed), because it was still investigating whether or not the practice was widespread. Before announcing any need to restate, the company disclosed the loss of a major contract, which drove its stock price down considerably. By the time the need to restate was announced, most of the inflation had already been removed from stock price.

60. All the elements of the common law tort of fraudulent misrepresentation, other than intent to induce reliance, have been incorporated in the proof of federal securities law violations under Rule 10(b). See, e.g., *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta*, 552 U.S. 148, 165 (2008).

misstatements, i.e., the company had “information that would lead a reasonable man to conclude that there is an especial likelihood that it will reach those persons and will influence their conduct.”<sup>61</sup>

Evidence of such intent to induce reliance should be considered in determining whether defendants’ conduct distorted the market price. It stands to reason that companies should be held accountable if they knowingly managed the release of news in the hopes of obscuring any distortion attributable thereto, whether to meet analyst expectations or to blunt the impact of corrective revelations. In this regard, any delay in the release of adverse news, or deliberate combination with other information, should be a red flag.

#### *H. Investors’ Reliance on the “Integrity of Management”*

In analyzing confounding events, it is also important to factor the market’s risk assessment of the stock. It has long been recognized that market-price reactions to earnings restatements are often disproportionate to the size of the restatement.<sup>62</sup> Indeed, if one were to recast the actual earnings over the restated period, and use the same price/earnings multiplier, the reconstructed “true value” price of the stock would likely be quite different from the price reconstructed based on the price drop following the corrective disclosure. In other words, if the company had been forthright in the first instance, the stock would have been lower, but not as low as indicated by the post-corrective price.

The larger reaction to a corrective disclosure clearly involves an additional factor—the market’s perception of management’s reliability. After all, stock pricing is a function of future returns, the assessment of which requires confidence in management. As Professor Langevoort observed: “[p]resumably, most stock-price declines that follow a surprise revelation of fraud reflect not only the truth with respect to the specific facts misrepresented or omitted but also a readjustment in expectations regarding other matters on which management was

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61. *Ernst & Young, LLP v. Pac. Mut. Life Ins. Co.*, 51 S.W.3d 573, 581 (Tex. 2001) (citing RESTATEMENT (SECOND) OF TORTS § 531 cmt. d (1977)); see *Enron Corp. Sec., Derivative & “ERISA” Litig. v. Enron Corp.*, Nos. H-01-3624, G-03-0481, 2010 WL 9077875, at \*46 (S.D. Tex. Jan. 19, 2010) (applying Restatement § 531 to sustain fraud allegations in connection with open market purchases made in reliance on SEC filings because there was “an especial likelihood that SEC-filed [information] . . . will reach and influence potential investors to purchase the company’s stock”); *Berkowitz v. Baron*, 428 F. Supp. 1190, 1196 (S.D.N.Y. 1977) (finding that the plaintiffs were in the class of persons that was reasonably expected to rely on the statements).

62. See *Bruegger & Dunbar*, *supra* note 49, at 34 (“For a growth stock, the first announcement could be expected to have a disproportionately larger effect than subsequent announcements.”).

previously thought credible.”<sup>63</sup>

Bruegger and Dunbar also acknowledge that this loss of confidence by the market contributes to the price reaction:

[I]t is likely that the earnings response coefficient is not constant if there are multiple earnings surprises resulting from disclosures of false accounting. For a growth stock, the first announcement could be expected to have a disproportionately larger effect than subsequent announcements. . . . This is because the initial price reaction would include a component that reassesses the risk of ensuing bad news.<sup>64</sup>

Indeed, it is well established in the finance literature that the ramifications of financial fraud extend well beyond the direct dollar amount of the fraud, but also cause further loss on account of damage to a company’s reputation:

Risk/uncertainty likely increases and future prospects may well decrease when management integrity and competence are called into question.

. . .

Because fraud means intentional, non-GAAP financial reporting, it indicates a lack of management integrity that we expect to be associated with a more negative stock price reaction, incremental to any other impacts from revising reported results. This may be due to an increase in the discount rate because fraud creates uncertainty about the reliability and credibility of management representations, which increases the perceived information asymmetry between management and stockholders.

. . .

Our results suggest a greater investor concern over restatements that carry negative implications for management integrity than those due to more technical accounting issues.<sup>65</sup>

Other studies have quantified the impact of management “reputation” on the value of securities.

One study quantified the impact of reputational impairment on the price of company stocks: “For each dollar that a firm misleadingly inflates its market value, on average, it loses this dollar when its misconduct is revealed,” *plus an additional \$2.71, due to reputation loss*.<sup>66</sup> As the authors noted:

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63. Langevoort, *supra* note 7, at 183 n.140.

64. Bruegger & Dunbar, *supra* note 49, at 34.

65. Zoe-Vonna Palmrose et al., *Determinants of Market Reactions to Restatement Announcements*, 37 J. ACCT. & ECON. 59, 63, 87 (2004).

66. Jonathan M. Karpoff, D. Scott Lee & Gerald S. Martin, *The Cost to Firms of Cooking the Books*, 43 J. FIN. & QUANTITATIVE ANALYSIS 581, 581 (2008).

Reputation can be lost if customers change the terms on which they are willing to do business with the firm because of an increased probability of cheating or the perception that the firm cannot support warranties or supply compatible parts in the future. Diminished reputation also can reflect an increase in the firm's cost of capital or trade credit, as input suppliers change the terms with which they do business with the firm. In addition, the firm can suffer real losses as managers are required to divert resources to the investigation and away from company business. The revelation of financial reporting problems could also force the firm to implement new monitoring and control policies, increasing the cost of operations. We group all such real effects on firm value into the reputation loss.<sup>67</sup>

Thus, investors should be entitled to recover this additional decline attributable to the market's reassessment of management's "risk." Just as courts have consistently recognized investors' entitlement to rely upon the "integrity of the market," so too should investors be entitled to rely upon the "integrity of management."

Indeed, courts have been moving in that direction.<sup>68</sup> Indeed, "[i]nvestors have a right to know—and would reasonably consider it important—when the head of a publicly-owned company is stealing any quantity of money from their company."<sup>69</sup>

The SEC has officially embraced this view: "[T]he tone set by top management—the corporate environment or culture within which financial reporting occurs—is the most significant factor contributing to the integrity of the financial reporting process."<sup>70</sup> So too has the Public Company Accounting Oversight Board ("PCAOB"): Auditing standards require that "[f]raud involving senior management . . . should be

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67. *Id.* at 598–99 (footnote omitted).

68. See *S.E.C. v. Das*, No. 8:10CV102, 2010 WL 4615336, at \*8 (D. Neb. Nov. 4, 2010) ("Investors may base their investment decisions, at least in part, on factors such as . . . management ethics and accountability."); *Voit v. Wonderware Corp.*, 977 F. Supp. 363, 370–73 (E.D. Pa. 1997) (finding resignation of CEO material where CEO brings "peculiarly valuable technical or business expertise to the company" and the stock drops after resignation announcement (citing *In re Numerex Corp. Sec. Litig.*, 913 F. Supp. 391, 401 (E.D. Pa. 1996))).

69. *S.E.C. v. Pace*, 173 F. Supp. 2d 30, 33 (D.D.C. 2001); accord. *AUSA Life Ins. Co. v. Ernst & Young*, 206 F.3d 202, 237 (2d Cir. 2000) (Winter, J., dissenting) (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); *United States v. Hatfield*, 724 F. Supp. 2d 321, 328 (E.D.N.Y. 2010) ("Here, a reasonable jury could find that [the defendant] spent millions of dollars of shareholders' money on his personal expenses, without proper authorization to do so. . . . This more than suffices to meet the Government's materiality burden."); see also *Dunbar & Sen*, *supra* note 56, at 237–38; *Langevoort*, *supra* note 7, at 183 n.140.

70. SEC Staff Accounting Bulletin No. 99, Materiality, 64 Fed. Reg. 45150, 45155 (Aug. 19, 1999) (to be codified at 17 C.F.R. pt. 211(B)), cited in *Ganino v. Citizens Utils. Co.*, 228 F.3d 154, 163 (2d Cir. 2000).

reported directly to the audit committee in a timely manner . . . .”<sup>71</sup>

CONCLUSION—NEW MATH AND THE “UNANIMOUS DECISION”

Thus, the landscape for securities fraud class actions has been altered, though there is an element of “déjà vu all over again” with the addition (or return) 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.”<sup>72</sup>

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

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71. PCAOB AU § 316.79, “Consideration of Fraud in a Financial Statement Audit,” available at <http://pcaobus.org/Standards/Auditing/pages/au316.aspx>.

72. Langevoort, *supra* note 7, at 168.