The Significance and Impact of Price Distortion and the Fraud-on-the-Market Theory after Halliburton II

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The Significance and Impact of Price Distortion in the Fraud-on-the-Market Theory after Halliburton II

Charles W. Murdock*

This past summer, the United States Supreme Court handed down its decision in Halliburton v. Erica P. John Fund, Inc. ("Halliburton II"), in which the Court held that a defendant may establish lack of price impact at the certification stage to establish a lack of reliance based upon the fraud-on-the-market theory. This was the third decision in three years dealing with the fraud-on-the-market approach to establishing commonality with respect to reliance by plaintiffs on management’s misrepresentations. In so doing, the Supreme Court retained market efficiency as an element of the fraud-on-the-market theory, but also reflected a broader and less restrictive approach to market efficiency than had been adopted by some of the circuit courts.

By permitting defendants to establish a lack of price impact, which plaintiffs will certainly challenge, this Article asserts that, because price impact is linked to both loss causation and materiality, which previous Supreme Court decisions have determined need not be established at the certification stage, the Court has open the door to the litigation of complicated, fact-based issues at the certification stage, rather than at a trial on the merits where the litigation of such issues should properly take place.

While there has not been much litigation as of yet applying Halliburton II, courts thus far have held defendants to a substantial burden in establishing a lack of price impact. Nonetheless, this Article suggests that it is the misleading information injected into the market by defendants upon which plaintiffs rely, not the market price, and that certification should be a summary proceeding, leaving complicated and complex issues of price impact, materiality, and loss causation to a trial on the merits. Otherwise, the present approach raises as yet unresolved issues as to issue preclusion, law of the case, and the Seventh

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INTRODUCTION

This Article was sparked by the panel discussions at the Institute for Investor Protection Conference, “The New Landscape of Securities Fraud Class Actions,” jointly sponsored by Loyola University Chicago School of Law and the Institute for Law and Economic Policy (“the Investor Protection Conference”). The conference program was triggered by the Supreme Court’s recent decision in Halliburton v. Erica P. John Fund, Inc. (“Halliburton II”).

One would think that, after three Supreme Court decisions dealing with the fraud-on-the-market theory in the past three years, the law in this area would be effectively settled. Unfortunately, to the extent that the law is “settled,” it is been settled in a very unsatisfactory manner. Briefly stated, the Supreme Court retained the fraud-on-the-market theory as a vehicle to establish reliance in securities class actions, much to the chagrin of Justices Thomas, Alito, and Scalia. But, in so doing, the Court also retained the notion that plaintiffs rely upon the market price in an efficient market as the basis for establishing reliance. The nuance that the Court added was that defendants, at the certification stage, could introduce evidence as to the lack of price impact. The previous Supreme Court decisions had held that plaintiffs need not establish loss causation at the class-certification stage, and that they also need not prove materiality at this stage.

3. Halliburton II, 134 S. Ct. at 2417 (Ginsburg, J., concurring).
4. Id.
5. Halliburton I, 131 S. Ct. at 2179.
6. Amgen, 133 S. Ct. at 1203.
As I have discussed in another article, the same evidence may establish all three of these factors: loss causation, materiality, and price impact. These are all fact-intensive questions that should be decided after a trial on the merits, not in a summary proceeding to determine class certification. Consequently, because price is the result of misleading information, I have argued that it is more logical, from a normative standpoint, to presume that a plaintiff relies on the misleading information. Thus, all that should need to be established at class certification is that defendants interjected material misleading information into the market. At this point, materiality would be an objective element, namely, a question of whether this information was the sort of information upon which a reasonable investor would be expected to rely.

The Supreme Court has continued us on the track of focusing on price and whether the questioned information was inserted into an efficient market, whatever that now means. This perpetuates the role of federal courts in determining whether or not a market is efficient, a question that arguably is incapable of answer because it assumes that market efficiency is a binary question—yes or no—when, in actuality, there are degrees of market efficiency. The majority opinion by Justice Roberts is somewhat paradoxical because Justice Roberts recognized that market efficiency is not a binary question. Moreover, he seemed to agree with the proposition that the speed with which information is impounded into any market is a function of the complexity of the information, the manner and timing of the distribution of the information, and other factors: "[Basic, Inc. v. Levinson did not] adopt any particular theory of how quickly and completely publicly available information is reflected in market price."

This Article briefly reviews in Part II the concept of market efficiency after Justice Roberts’ opinion in Halliburton II. In Part II, it explores the law of the case and issue-preclusion ramifications of permitting defendants, in a mini-trial, to establish a lack of price impact.

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8. Id.
to rebut the presumption of reliance. Part III looks at two models as to how price distortion can occur and argues that, with respect to confirmatory statements, the relevant price impact occurs upon the corrective disclosure. Finally, Part IV reviews the significant cases after *Halliburton II* to examine how they handled the issue of defendants’ negating price impact. The conclusion asserts that the present approach to establishing reliance is wasteful and inefficient.

I. THE SUPREME COURT AND MARKET EFFICIENCY

As indicated in the introduction, the recent decision in *Halliburton II* should provoke a re-examination of the concept of market efficiency. While Justice Roberts eschewed relying upon the economists’ view as to whether it is possible for an individual investor to “beat the market” as the determinant for an efficient market, the opinion provided little guidance as to what the proper test would be. Justice Roberts implicitly recognized that Nobel Prize-winning economists have taken opposite views on whether markets are efficient. In so doing, he stated:

Even the foremost critics of the efficient-capital-markets hypothesis acknowledge that public information generally affects stock prices. *See, e.g.*, Shiller, *We’ll Share the Honors, and Agree to Disagree . . .* (“Of course, prices reflect available information”). *Halliburton* also conceded as much in its reply brief and at oral argument. See *Reply Brief* 13 (“market prices generally respond to new, material information”); *Tr. of Oral Arg.* 7. Debates about the precise degree to which stock prices accurately reflect public information are thus largely beside the point. “That the . . . price [of a stock] may be inaccurate does not detract from the fact that false statements affect it, and cause loss,” which is “all that *Basic* requires.”

Justice Roberts also stated that *Basic, Inc. v. Levinson* “based the [fraud-on-the-market] presumption on the fairly modest premise that ‘market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices,’” and that “academic debates discussed by *Halliburton* have not refuted the modest premise underlying the presumption of reliance.” He also noted that, in adopting the fraud-on-the-market theory, that *Basic* did not adopt “any particular theory of how quickly

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13. *Id.*
15. *Id.* (quoting *Basic*, 485 U.S. at 246 n.24).
16. *Id.*
and completely publicly available information is reflected in market price.”\textsuperscript{17}

What conclusion can we draw from the foregoing? This is a pretty low threshold for determining market efficiency—a far cry from the incredibly narrow and restrictive view taken by what is generally considered the leading case on determining market efficiency: \textit{In re PolyMedica Corp. Securities Litigation}.\textsuperscript{18}

Justice Roberts, in asserting that the fraud-on-the-market presumption is actually two presumptions, stated that the plaintiff is entitled to her presumption that the misrepresentation affected the stock price if the plaintiff can show that the misrepresentations were public and material and that the stock “traded in a generally efficient market.”\textsuperscript{19} He followed this assertion by stating that “[b]ecause market efficiency is not a yes-or-no proposition, a public, material misrepresentation might not affect a stock’s price even in a generally efficient market.”\textsuperscript{20} The corollary of this statement is that a public, material misrepresentation might affect the stock’s price even in a generally inefficient market.

Consider the foregoing now in the context of events studies. To support the majority holding that a defendant should be able to demonstrate lack of price impact to defeat the fraud-on-the-market presumption, Justice Roberts used the following hypothetical:

Suppose a defendant at the certification stage submits an event study looking at the impact on the price of its stock from six discrete events, in an effort to refute the plaintiffs’ claim of general market efficiency. All agree the defendant may do this. Suppose one of the six events is the specific misrepresentation asserted by the plaintiffs. All agree that this too is perfectly acceptable. Now suppose the district court determines that, despite the defendant’s study, the plaintiff has carried its burden to prove market efficiency, but that the evidence shows no price impact with respect to the specific misrepresentation challenged in the suit. The evidence at the certification stage thus shows an efficient market, on which the alleged misrepresentation had no price impact. And yet under EPJ Fund’s view, the plaintiffs’ action should be certified and proceed as a class action (with all that entails), even though the fraud-on-the-market theory does not apply and common reliance thus cannot be presumed.\textsuperscript{21}

\begin{itemize}
\item \textsuperscript{17} \textit{Id.} at 2410 (quoting \textit{Basic}, 485 U.S. at 248 n.28).
\item \textsuperscript{18} \textit{In re PolyMedica Corp. Sec. Litig.}, 432 F.3d 1, 3 (1st Cir. 2005).
\item \textsuperscript{19} \textit{Halliburton II}, 134 S. Ct. at 2414.
\item \textsuperscript{20} \textit{Id.}
\item \textsuperscript{21} \textit{Id.} at 2415.
\end{itemize}
Justice Roberts asserted that the foregoing hypothetical reflects an efficient market, even though it may only have been “efficient” in five of six instances. The failure of the misrepresentation to move the markets may have been because the misrepresentation was not material. But it could also have been because the market was not efficient. What if there was price impact in only four of six instances? Or three of six instances? At what point would a market be considered “generally efficient”?

This comes back to the question of why we litigate market efficiency at all. Paradoxically, while Justice Roberts recognized that market efficiency is not a “yes or no” question, “yes or no” is exactly what a trial court must determine, so long as the focus is upon market efficiency.

Consider another twist to Justice Roberts’ hypothetical: What if the converse of his hypothetical were true, namely, there was no price impact in five of the events studies but there was a significant price impact in the sixth study that measured the price impact resulting from misrepresentations being litigated? Here we would have a situation in which the market would probably not be considered even “generally efficient”; yet, the misrepresentation challenged by plaintiff clearly moved the market. This is not an outlandish twist on Justice Roberts’ hypothetical. Consider the PolyMedica litigation in which the district court, on remand from the First Circuit, determined that the market was not efficient, notwithstanding the following price movements: a 49.54% decline on reports of consumer complaints to government investigators; a 42.65% rise on PolyMedica’s response that those reports were rumors and that it had not been contacted by any government agency; a 29.52% decline on the announcement that shares would no longer be listed on the New York Stock Exchange (“NYSE”); a 32.17% decline on a report that PolyMedica may be indicted for Medicare and investor fraud; a 17.65% decline on the announcement by the company that the U.S. Attorney for the Southern District of Florida was conducting an investigation into one of its units.

Unfortunately, the district court “bought” the testimony of defendant’s expert who asserted that, within a 160 day period, there were somewhere between 23 and 59 news days where the movement of the market was not substantially different from a non-news day.
Consequently, the court concluded that the market was not efficient.\textsuperscript{25} But apparently, there was no testimony by the defendant’s expert as to the significance of the “news” on the so-called news days. It is unlikely that, on 23 to 59 so-called news days, there would have been disclosures as dramatic as the allegations of Medicare fraud, denial of listing by the NYSE, or a possible criminal indictment.

The foregoing should illustrate the folly of litigating market efficiency as opposed to price impact. If the misrepresentation moved the market, and if a plaintiff bought at a price that was affected by the misrepresentation and later sold at a lower price once the truth was revealed, has the plaintiff not been defrauded by the misrepresentation? A fraud-on-the-market “purist” might respond that each plaintiff during the period has been defrauded, but that there was no common reliance and therefore no certifiable class action. This is basically the approach of Justice Thomas in his concurring opinion. But this means the end of securities litigation for the numerous plaintiffs whose loss is not sufficient to warrant the hundreds of thousands of dollars in litigation expenses that are typically involved in securities litigation.\textsuperscript{26}

While, as Justice Roberts asserts, it would be “bizarre”\textsuperscript{27} if a plaintiff could have a class certified when the misrepresentation challenged by the plaintiff had no market impact, it would be just as bizarre if a class were not certified when the plaintiff demonstrated that the misrepresentation caused a price impact, irrespective of the issue of how “efficient” the market is in other circumstances. While the efficient market hypothesis argues that an efficient market would be fooled by any and all instances of fraud, such expansive evidence “is unnecessary to demonstrate that the market was fooled by a particular statement.”\textsuperscript{28}

This was very cogently argued over two decades ago:

Why should we, however, limit the presumption to traders in efficient organized markets? The efficient market hypothesis cannot take credit for the insight that information affects prices. As Justice Blackmun acknowledged, an organizing principle of securities regulation since its inception is that misinformation distorts the prices of stocks, small as well as large—albeit sometimes more slowly and imprecisely with

\textsuperscript{25} Id. at 270, 278.

\textsuperscript{26} This is why I have argued that investors generally rely upon the integrity of the information that management inserts into the marketplace.

\textsuperscript{27} Halliburton Co. v. Erica P. John Fund, Inc. (\textit{Halliburton II}), 573 U.S. —, 134 S. Ct. 2398, 2415 (2014).

respect to the former. A buyer of a small over-the-counter stock no doubt holds the same expectation of the absence of fraud (otherwise why would she roll the dice, to repeat Justice Blackmun’s rhetorical question), and does not act in an appreciably more unreasonable fashion in so doing. In this light, discriminating between investors in small and large companies makes no conceptual sense. The only important question is whether the price was distorted. Given the well-acknowledged practical and conceptual difficulties of determining what is or is not a truly efficient market—various conundra that all stem from treating efficiency as a yes/no question rather than one that varies as a matter of degree depending on the type of issuer and the type of information—there are good reasons to want to avoid this sort of threshold inquiry. Yet Basic seems to insist on it.29

While Basic may seem to insist upon it, the logic of Justice Roberts’ opinion in Halliburton II arguably does not.

II. THE SIGNIFICANCE OF LITIGATING PRICE DISTORTION FROM A LAW OF THE CASE OR ISSUE PRECLUSION PERSPECTIVE

From another perspective, I would argue that a defendant, seeking to take advantage of the “benefit” afforded by the decision in Halliburton II should proceed with caution and be aware of the adage “be careful what you ask for, you just might get it!” Suppose a defendant seeks to show the lack of price impact and fails. While this does not mean, as a corollary, that the plaintiff can now demonstrate the existence of price impact, practically speaking, the plaintiff is now in a much better position, as the court has determined that the defendant’s argument is dubious.

More importantly, once the defendant seeks to produce evidence demonstrating a lack of price distortion, the plaintiff will certainly produce evidence demonstrating the existence of price distortion.30 In connection with the class-certification process, Justice Roberts, speaking for the majority, clearly envisions a mini-trial.31 In rebutting

29. Langevoort, supra note 9, at 897–98.
31. This assertion was also rejected by the Alabama District Court in Regions, where the court stated: “[s]urely the Supreme Court in Halliburton II did not intend to turn the class certification stage of securities litigation into a trial on the merits of plaintiffs’ claims.” Regions, 2014 WL 6661918, at *10. Only time will tell which assertion is correct.
the plaintiff’s argument that price distortion, like materiality, need not be proved at the class-certification stage, Justice Roberts stated that “the other Basic prerequisites must still be proved at the class certification stage.” He then distinguished price distortion from materiality as follows:

Price impact is different. The fact that a misrepresentation “was reflected in the market price at the time of [the] transaction”—that it had price impact—is “Basic’s fundamental premise.” It thus has everything to do with the issue of predominance at the class certification stage. That is why, if reliance is to be shown through the Basic presumption, the publicity and market efficiency prerequisites must be proved before class certification. Without proof of those prerequisites, the fraud-on-the-market theory underlying the presumption completely collapses, rendering class certification inappropriate.

By litigating price distortion at the class-certification stage, the distinction that some courts have drawn between the scope of discovery prior to class certification and the scope of discovery in connection with the trial on the merits becomes meaningless. Price distortion is inextricably intertwined with materiality and loss causation. Thus, an attempt to limit discovery at class certification would be akin to splitting hairs. As Judge Shira A. Scheindlin pointed out at the conference: “We are now litigating whether or not there is price impact and guess who is deciding that question? It’s the judge! It’s a three-day ‘hearing’ with witnesses, with exhibits . . . .”

Consequently, when the defendant puts price distortion at issue, we now have a mini-trial in which evidence is adduced and full discovery should be available. And the judge must make a decision that there either is price distortion or that there is not price distortion. This then raises the further issue of issue preclusion, or at least the law of the case doctrine. Because this decision is made in the context of class

32. *Halliburton II*, 134 S. Ct. at 2416 (emphasis added).
33. *Id.* (citing Erica P. John Fund, Inc. v. Halliburton Co. (*Halliburton I*), 131 S. Ct. 2179, 2186 (2011)). *Amgen* and *Halliburton II*, taken together, mean that materiality, although an element of the fraud-on-the-market theory, which establishes reliance, need not be established at the certification stage.
34. Murdock, *supra* note 7, at 245.
36. See 18 J. MOORE ET AL., *MOORE’S FEDERAL PRACTICE* § 132.01, ¶ 2 (3d ed.) (“Generally, the doctrine of issue preclusion will prevent a party from relitigating an issue that the party has already litigated and lost . . . .”).
37. See *id.* § 134.24 (“Once an appeal is taken and an issue is decided, that decision becomes
certification, the decision is appealable.

Issue preclusion provides that, once a factual issue has been determined in a proceeding between two parties, that issue may not be relitigated. Thus, if at a contested, evidentiary hearing at which discovery was available, there is a determination of either price impact or no price impact, that issue should be resolved for the balance of the litigation, whether by issue preclusion or the law of the case. Otherwise, a contested issue, which is both critical and which involves substantial cost in expert testimony and judicial involvement, will be relitigated. This clearly is not consonant with a system of judicial economy.

There are two circuit court decisions that bear on this question of whether the resolution of a matter at a certification hearing can have subsequent preclusive effect. *Alaska Electrical Pension Fund v. Flowserve Corp.* rejected the preclusive effect from a certification proceeding, whereas *In re Bridgestone/Firestone, Inc., Tires Products Liability Litigation* applied preclusion arising from a certification determination.

*Flowserve* dealt with the issue of whether a determination at the class-certification stage that found the lack of loss causation intruded upon the plaintiff’s Seventh Amendment right to a jury trial in civil matters. The Fifth Circuit had previously held that “loss causation [as an issue of predominance] must be established at the class certification stage by a preponderance of all admissible evidence,” a position subsequently rejected by the Supreme Court in *Halliburton I*. In *Flowserve*, the plaintiff argued that a determination of loss causation at the certification stage would have “the potential for intruding on plaintiffs’ [Seventh Amendment] right to a jury trial,” as the issue of

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40. Alaska, 572 F.3d at 228.
41. Oscar Private Equity Investors v. Allegiance Telecom, Inc., 487 F.3d 261, 269 (5th Cir. 2007).
42. Erica P. John Fund, Inc. v. Halliburton Co. (*Halliburton I*), 131 S. Ct. 2179, 2185–86 (2011). While loss causation cannot be litigated at the certification stage, under *Halliburton II*, defendant can litigate the related issue of price impact, to which plaintiff most likely will respond.
43. Alaska, 572 F.3d at 228.
loss causation should be presented to the jury at the merits stage. The Fifth Circuit rejected this argument, stating:

This argument fails because it conflates the issue of loss causation for purposes of establishing predominance under Rule 23 with the issue of loss causation on the merits. “In determining the propriety of a class action, the question is not whether the plaintiff or plaintiffs have stated a cause of action or will prevail on the merits, but rather whether the requirements of Rule 23 are met.”

While it is true that the certification decision is not concerned with whether or not the plaintiff will prevail on the merits, what is being considered in connection with price impact is not claim preclusion, but rather issue preclusion. On this, and other issues to be discussed later, the Flowserve opinion does not manifest a very sophisticated grasp of securities litigation.

It is sophistry to say that a determination with respect to price impact at the certification stage involves considerations different from those to be determined at the merits stage. By moving the certification issue from a summary proceeding to a mini-trial, involving a contested hearing and a judicial finding, the issue of price impact is ripe for claim preclusion. Because price impact is relevant both to determinations regarding materiality and determinations regarding loss causation, it can be expected that, should price impact be put in issue at the certification stage, it will be highly contested. While the Advisory Committee Notes to Rule 23 state that a “determination once made can be altered or amended before the decision on the merits if, upon fuller development of the facts, the original determination appears unsound,” if an issue is fully litigated at the certification stage, judicial economy should dictate that it should not be relitigated at the merits stage.

On the other hand, Bridgestone recognized the applicability of preclusion arising from a class-certification determination. The Seventh Circuit had previously held in this litigation that the district
court had abused its discretion by certifying nationwide classes covering multiple models of Ford vehicles and Firestone tires. The defendants then sought an injunction forbidding any state court to entertain any class action of any kind with respect to the alleged defective products. The Seventh Circuit held that “the only classes that had been certified had national scope, and the only judgment that could be protected or effectuated is one concerning such classes.” The Seventh Circuit noted that the “district court had not certified, and in our opinion thus did not address, any statewide class.” The court stated that “[w]hat we did hold is that a class covering owners in every state may not be certified over the defendants opposition,” and this holding was given preclusive effect.

While it could be argued that the preclusive effect enforced by the Seventh Circuit involved “parallel” determinations, namely, that it applied to subsequent certification decisions, whereas giving preclusive effect to a price impact determination at the certification stage involves a “series” determination, i.e., a subsequent determination in the same litigation, both involved judicial economy and that a decision, once made, should not be relitigated.

III. WHEN AND HOW IS PRICE DISTORTION MEASURED

There are two basic paradigms involving fraudulent misrepresentations. The first is illustrated by the graph below:

![Graph](image)

This involves a situation where there is a relatively stable price and the management of the issuer makes a fraudulent statement that, generally, is aimed at raising the price of the issuer stock. This is a so-

49. *In re Bridgestone/Firestone, Inc., Tires Prods. Liab. Litig.*, 288 F.3d 1012, 1018–21 (7th Cir. 2002).
50. *In re Bridgestone*, 333 F.2d at 765.
51. *Id.* at 766.
52. *Id.*
53. *Id.*
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called “good news” situation. The market responds to the positive statement, the price increases, and basically holds for a period of time. Then the truth is disclosed and the price drops. Here, there is price impact both at the time of the misstatement and at the time of the truthful correction.

While the foregoing situation does exist, another, and possibly more typical, situation arises when there has been a series of positive developments and then an unanticipated problem occurs. Rather than acknowledging the problem, management continues to make positive statements that are designed, not necessarily to increase the price of the stock, but to retard a decline. This is illustrated by the graph below:

Clearly, there may be no price movement as a result of the misrepresentations but, as a sophisticated analysis would appreciate,

54. Paradoxically, Basic involved a “bad news” situation, namely, management denied the existence of takeover discussions, which had the effect of arresting an increase in price or possibly causing a drop in price. Basic, Inc. v. Levinson, 485 U.S. 224, 226–28 (1988).

55. In Aranaz v. Catalyst Pharmaceutical Partners Inc., the price of the stock rose approximately 40% as a result of the misrepresentation on August 27, 2013 ($1.42 to $2.01) and then dropped about 40% after the truth was revealed on October 18, 2013 ($2.61 to $1.52). Aranaz v. Catalyst Pharm. Partners Inc., 302 F.R.D. 657, 662 (S.D. Fla. 2014).

56. For example, in In re Silicon Graphics Inc. Securities Litigation, the company had reported a 45% revenue growth for the preceding fiscal year and had projected similar growth for the current year. In re Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 980 (9th Cir. 1999). Revenue growth for the first quarter was only 33% and, to counter a feared drop in the price of the company’s stock, management made a series of announcements over a three-month period that the first-quarter results for outliers and that the company would achieve its projected growth. Id. at 981. In fact, the company had been experiencing problems in its supply chain and with that sales-force. Id. While the misleading statements temporarily supported the price of the company’s stock, when the company announced disappointing second-quarter results, the price of the stock dropped to about 50%. Id. at 982. Similarly, in Makor Issues & Rights v. Tellabs Inc., management engaged in channel stuffing, and issued denials that there were potential revenue problems, in order to support the price of the stock. Makor Issues & Rights, LTD. v. Tellabs Inc., 437 F.3d 588, 604–05 (7th Cir. 2006), vacated and remanded to Makor Issues & Rights, LTD. v. Tellabs Inc., 551 U.S. 308 (2007).
there is clearly price distortion because, if the truth were told, the price would decline as opposed to remaining stable.

The Seventh Circuit dealt with this issue in *Schleicher v. Wendt* 57 Canseco’s management had made misleading positive statements during the course of 2001 and 2002 as Canseco stock was doing poorly, apparently seeking to retard the price decline. Canseco eventually filed for bankruptcy in May 2010. The defendant’s argument apparently was that the price of the stock was dropping irrespective of the misrepresentations. In rejecting this argument, the Seventh Circuit stated:

That Canseco stock was falling during the class period is irrelevant; fraud could have affected the speed of the fall. If a firm says that it lost $100 million, when it actually lost $200 million—and analysts had expected it to announce that it lost only $50 million—then the announcement will cause a stock’s price to fall. But the fall won’t be as much as the truth would have produced. People buy the stock after the announcement, and before the truth comes out, pay too much; they will lose money when the rest of the bad news emerges. This is no different in principle from a firm’s announcement of a $200 million profit, when the truth is $100 million; only the signs on the numbers differ.58

While Judge Easterbrook’s wisdom should be evident, not all courts understand this basic operation of the market. Consider the situation in *Flowserve* 59—previously discussed in connection with issue preclusion.60 The issue discussed by the court dealt with loss causation; however, the flaw in the court’s analysis is equally applicable to price distortion analysis.

*Flowserve* reported earnings of $13.2 million for fiscal year (“FY”) 2000, when true earnings were $5.4 million.61 An April 24, 2001, announcement reported positive first-quarter earnings, which overstated earnings and understated costs, and the stock price increased 8%.62 On July 24, 2001, the company released inflated earnings again, but reduced its 2001 earnings guidance, causing the stock to drop 10.8% on the day of the release, but rebounding by 7.7% the next day.63

57. Schleicher v. Wendt, 618 F.3d 679, 683–84 (7th Cir. 2010).
58. Id. at 684.
60. See supra text accompanying notes 40–47 (discussing the Fifth Circuit’s approach to issue preclusion).
61. Alaska, 572 F.3d at 225.
62. Id. at 225–26.
63. Id. at 226.
October 22, 2001, the company again released inaccurate and overstated third-quarter results and the stock price rose 6.8%. According to the plaintiff, Flowserve also engaged in fraud when it knowingly released overly optimistic FY 2002 earnings guidance on October 22. The company again misstated its fourth-quarter results on February 4, 2002.

In July 2002, Flowserve revised its FY 2002 guidance downward, and the stock declined 37.4%. It declined another 38.3% after the guidance was reserved downward again in September. On February 3, 2004, the company announced that it would downwardly restate earnings for the period 2000–2003 by $11 million. No statistically significant decline in the price of its stock occurred after this disclosure. Eventually the company restated its earnings downward by almost $60 million.

In analyzing the foregoing facts, the Fifth Circuit rejected the defendant’s argument that the “plaintiff must show a ‘fact-for-fact’ disclosure of information that fully corrected prior misstatements.” If this is what the plaintiff would need to prove to establish loss causation, there would be no loss causation, as the only fact-for-fact disclosure was in connection with the restatement and no statistically significant drop in the price of the stock occurred at that point. Instead, the Fifth Circuit required that “this disclosed information must reflect part of the ‘relevant truth’—the truth obscured by the fraudulent statements.” In the abstract, it would be difficult to quarrel with the statement. But the relevant question is: What does it mean and how is it proved?

There were two different types of misleading statements involved in the case. One group related to the disclosure of inflated earnings, the second group related to the projections involved in earnings guidance. The Fifth Circuit focused upon the latter, because the former would not be actionable under the approach taken by the Fifth Circuit in its earlier case of Greenberg v. Crossroads Systems, Inc.
In *Greenberg*, the plaintiffs alleged that the reported earnings for the first quarter of FY 2000 and detailed analysts’ earnings estimates for the second quarter were inflated. The plaintiffs also alleged that the third-quarter earnings were inflated. The company had issued a press release subsequent to the disclosure of the third-quarter earnings that had predicted a significant revenue shortfall for the third-quarter. The Fifth Circuit held that there was no relationship between the first and second quarter misstatements and a subsequent release because “[t]he release [did] not report any concern that first and second quarter earnings [were] incorrect.” Rather, “[i]t ma[de] no reference at all to [the] first and second fiscal quarters.”

This is both an unduly restrictive and a naïve approach to loss causation and, by implication, price distortion. A significant revenue shortfall for the third quarter could well be indicative of financial manipulation in the first and second quarters, particularly if channel stuffing were involved. As I pointed out in an earlier article arising out of the previous Institute for Investor Protection’s Conference:

channel stuffing is a form of Ponzi scheme: you rob sales from [Q2] to enhance [Q1]; then it becomes necessary to rob sales from [Q3] to enhance Q2. But the channel stuffing diversion in Q3 may likely exceed Q2 because then Q3 diversion needs not only to replace what was “robbed” in Q2 but also to enhance Q2.

The court in *In re Spectrum Brands, Inc. Securities Litigation* found that a sixty-one day period between stock sales by an executive and an announcement that sales would fall “woefully short of previous estimates” was not suspicious because of the “temporal distance”

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75. *Greenberg*, 364 F.3d at 668.
76. *Id.* at 664 n.8.
77. *Id.* at 668.
78. *Id.*
79. *Id.* (“The statements made on 22 February 2000 and 23 February 2000 reported Crossroads’s financial results for the first quarter of Fiscal Year 2000 and detailed analysts earnings estimates for the fiscal second quarter. The 27 July 2000 statement states only that ‘revenues for the [third] quarter may be as much as two-thirds below revenues for the prior quarter.’ The release does not report any concern that Crossroads’s first and second quarter earnings may be incorrect. Moreover, the 27 July 2000 release makes no reference at all to Crossroads’s first and second fiscal quarters. Because there is no relationship between the statement made on 27 July 2000 and those made on 22 February 2000 and 23 February 2000, Crossroads’s statements on these days cannot form the basis for a fraud-on-the-market claim.” (citations omitted)).
82. *Id.* at 1316–17.
between the sales and the announcement. Here again, the court did not understand the nature of channel stuffing and revenue manipulation:

This focus upon two months (sixty-one days) being significant, but sixty-nine days (May 20 to July 28) not being significant, is another example of living in an alternate universe. Channel stuffing often involves bringing sales back from a subsequent quarter into a prior quarter. By definition, the fraud will not be disclosed for ninety days, plus the period from the end of the subsequent quarter until disclosure is made. Thus, 100 days or more may expire between the time of the wrongful activity and the indirect announcement of its existence by virtue of lower revenues in the following quarter. If the channel stuffing extends over more than one quarter, the time span between commencement of the channel stuffing and the subsequent reduced revenues will be even longer.84

Were the channel stuffing to extend over two quarters, it could be 190 days or more before there would be any information provided to the market with respect to the fraud perpetrated months earlier.

Contrary to the Fifth Circuit’s decisions in Greenberg and Flowserve, the price impact of an announcement made with respect to a drop in revenues in the third quarter very likely could be related to fraudulent misstatements of earnings in the first two quarters.

The Fifth Circuit also opined that the corrective disclosure must be more pointed than simply indicating that “the market understood that there was some problem with Flowserve’s business.”85 A “general impression in the market that ‘something is wrong’ is insufficient to establish causation.”86 This statement by the court again reflects a lack of understanding of how markets work and also illustrates how corrupt-but-clever management can escape liability under the present regime of federal court jurisprudence.

Assume that the first- and second-quarter financial results discussed above were fraudulent, i.e., the company had fabricated revenues (whether by channel stuffing or other illicit means) in order to increase earnings and maintain the price of the company’s stock. What the company should do, and did in Greenberg and Flowserve, is

83. Id. at 1317.
84. Murdock, supra note 80, at 631.
85. See Alaska Elec. Pension Fund v. Flowserve Corp., 572 F.3d 221, 232 (5th Cir. 2009) (“Clearly, the market understood that there was some problem with Flowserve’s business (or its business environment) when the company reduced earnings guidance and the market reacted by driving down Flowserve’s share price. But loss caused solely by a general impression in the market that ‘something is wrong’ is insufficient to establish causation.”)
86. Id.
dramatically reduce its earnings or revenue guidance for the third quarter. What the market cares about is continued growth. Growth is a major factor in determining the stock price set by the market. If growth is to stop, or more significantly, plummet, this will have a dramatic downward impact on the price of a company’s stock.87

While the market is not indifferent as to the reason why revenues are plunging, when it looks like growth has evaporated, there will be a race to get out and the market price will drop sharply. The reality is that once “the market underst[ands] that there [i]s some problem with Flowserve’s business,”88 the price of its stock will drop. Thus, corrupt-but-clever management will send a signal that there is something wrong with the company’s existing business plan, e.g., that acquisitions are not panning out as anticipated. This, in turn, will cause the price of the stock to drop. Then it will be safe for management to identify the real problem with the company’s existing business plan, namely, that it was inflating revenues and/or earnings by channel-stuffing. But, when management discloses the actual fraud, the price of the stock will not drop because the market has already impounded a failing business plan into the price of the stock.

What courts need to understand is that it is possible to “manipulate” the price of the stock down without identifying the fraud that makes the company’s stock overpriced. In the foregoing example, it was the prospect of reduced revenues from the forward-looking disclosure of poor acquisitions that led to the drop in price. But what really caused the reduced revenues, and drop in market price was that the channel-stuffing caught up to the company when it could no longer fabricate sales.

The lack of demand for its product was known to management in quarters one and two when it hid this lack of demand by inflating

87. See Murdock, supra note 7, at 214 n.76:

When stock sells at a high price/earnings ratio, the value of the stock is heavily dependent upon the anticipated growth rate.

\[ CR = DR - G. \]

Therefore, the larger the growth rate, the lower the capitalization rate. The capitalization rate is inversely proportional to the price-earnings multiple. Thus, the larger the growth rate, the higher the price-earnings multiple. Since a rudimentary approach to the value of a company is earnings times the price-earnings multiple, a decrease in earnings [and, consequently, growth] is a double whammy: it reduces the earnings, and the reduced earnings lower growth and thereby increase the capitalization rate, consequently reducing the price-earnings ratio.

88. Alaska, 572 F.3d at 232.
revenues in these two quarters. Consequently, investors who bought the stock in quarters one and two at a price that was inflated because it impounded the existing expectations of the company’s product, revenues, and growth, paid a price that was higher than the price should have been had the actual facts been disclosed. As a result, the investors were injured by the false information inserted into the market by the company in quarters one and two and should be entitled to recover the difference between what they paid and what the stock was actually worth at the time of their purchase. Normally, the drop in price after the corrective disclosure is a good surrogate for what the price would have been had the truth been told in quarters one and two, assuming that there were no external factors which caused a general decline in stock prices. But, in the illustration I have used, the market price was pushed downward by the company’s disclosure of other factors, casting doubt on the profitability of the company’s existing business plan. Thus, the price after disclosure of the channel-stuffing is not an appropriate measure of loss causation.

The second group of misleading statements in Flowserve related to the October 2001 earnings guidance that was reduced about 60% in subsequent earnings guidance issued in July and September 2002. In this regard, the Fifth Circuit held that the corrective earnings guidance, and the correlative price decline, could have related to fraudulent earnings guidance in October 2001. But this is probably a short-lived victory for plaintiffs. With regard to this aspect of the case, the defendants argued that “any forward-looking statements they issued are protected by the Private Securities Litigation Reform Act’s safe-harbor provision.” The Fifth Circuit temporarily rejected this argument on the basis that it implicated disputed factual issues that should be addressed by the district court.

However, on remand, the plaintiffs will be confronted with the Reform Act’s safe-harbor provision which provides that a person is not liable with respect to a forward-looking statement to the extent that:

89. See Makor Issues & Rights, Ltd. v. Tellabs Inc., 437 F.3d 588, 591–93 (7th Cir. 2006), vacated and remanded to Tellabs, Inc. v. Makor Issues & Rights, 551 U.S. 308 (2007) (illustrating that the CEO made a series of positive and specific statements that one key product, the Titan 5500 was experiencing continued growth and that a newer product, the Titan 6500, was ready to ship. Contrariwise, demand for the 5500 was precipitously declining and the 6500 was not yet being produced).
90. Alaska, 572 F.3d at 226.
91. Id. at 231–32.
92. Id. at 235.
93. Id.
(A) The forward-looking statement is—
   (i) identified as a forward-looking statement, and is accompanied
   by meaningful cautionary statements identifying important
   factors that could cause actual results to differ materially from
   those in the forward-looking statement; or
   (ii) immaterial; or
(B) The plaintiff fails to prove that the forward-looking statement—
   . . .
   (ii) if made by a business entity; was—
      (I) made by or with the approval of an executive officer of
          that entity; and
      (II) made or approved by such officer with actual knowledge
          by that officer that the statement was false or
          misleading.94

The “or” in the above safe harbor is a critical word. Even if
management knows that the material in the forward-looking statement is
false, there is no liability if the statement is identified as forward-
looking and is accompanied by cautionary statements. In Harris v. Ivax
Corp.,95 the court determined that the safe-harbor provisions require the
court first to examine whether the statement was accompanied by
cautionary language. If so, the state of mind of the person making the
statement is irrelevant:

All of the statements that the plaintiffs claim to be false or misleading
are forward-looking. They were accompanied, moreover, by
“meaningful cautionary language.” Because we reach this conclusion,
we need not in this case enter the thicket of the PSLRA’s new
pleading requirements for scienter; if a statement is accompanied by
“meaningful cautionary language,” the defendants’ state of mind is
irrelevant.96

It will be rare that a forward-looking statement is made without being so

95. Harris v. Ivax Corp., 182 F.3d 799, 803 (11th Cir. 1999).
   (“The first prong of the safe harbor requires courts to examine only the cautionary statement
   accompanying the forward-looking statement. Courts should not examine the state of mind of the
   person making the statement.”). In a footnote, the court added:
   The plaintiffs do make a wholly unpersuasive argument that the defendants’
   knowledge of the need to reduce goodwill robs the projections of their forward-looking
   status. The statutory definition of “forward-looking statement” does not refer at all to
   the defendants’ knowledge of the truth or falsity of the statement, however; such
   knowledge is relevant only to liability in the safe harbor, and even there only when
   there is inadequate cautionary language.

Harris, 182 F.3d at 807 n.10.
identified and without being accompanied by cautionary statements.

This illustrates another ploy that corrupt-but-clever management can utilize to avoid liability. If management has made both misleading factual statements and misleading forward-looking statements that nonetheless had cautionary language, then management would provide a corrective disclosure with respect to the misleading forward-looking statements with the expectation that such acknowledgment would drive the price of the stock down. It would then issue a corrective statement with respect to the factual statements it had made and the price impact of the second corrective statement could then be minimal. Attempting to sort out how much price movement is caused by each of several misleading statements is somewhat akin to determining how many angels can dance on the head of a pin.

The Fifth Circuit in *Flowserve* well summarized the plight of a securities litigation class-action plaintiff: such person “must thread the eye of a needle made smaller and smaller over the years by judicial decree and congressional action.”

IV. THE IMPACT OF HALLIBURTON II ON SUBSEQUENT CASES

While, at the time this Article was written near the end of 2014, there were about two-dozen cases citing *Halliburton II*, most of them were only general citations. However, four of those cases contained extensive discussion of *Halliburton II*’s directive to permit defendant to establish a lack of price impact to defeat certification. These cases have generally been favorable to plaintiffs.

In the Eighth Circuit, the district court in *IBEW Local 98 Pension Fund v. Best Buy Co., Inc.*, rejected several arguments by the defendants opposing certification. The argument relevant to this Article was the assertion that the following two supposedly misleading statements on September 14, 2010 by Best Buy’s management during an earnings conference call had no price impact: “Best Buy was ‘on track to deliver and exceed [the] annual [earnings per share (“’EPS’”)] guidance’; and (2) that Best Buy’s earnings ‘are essentially in line with [Best Buy’s] original expectations for the year.’”

Best Buy generally traded in the $40s during the period in

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99. Id. at *1 (alteration in original).
question.100 Prior to the conference call and before the opening of the market, Best Buy issued a press release acknowledging a 0.1% decline in comparable store sales growth, lower revenue expectations and some other negative information.101 However, it also announced a $.20 increase in earnings per share guidance to a range of $3.55–$3.70 per share.102

The court treated the above two statements as factual, not forward-looking, and the plaintiff asserted that the defendants were aware of multiple significant facts that Best Buy was not on track to achieve the fiscal targets for 2011.103 In December, 2010, Best Buy made a corrective statement: “[O]n December 14, 2010, the Company reported 3Q11 EPS of $0.54, falling short of 3Q11 estimates. The Company also reported a decline in comparable store sales of 5%, and a decline in market share of 110 basis points. At that time, Defendants reduced FY11 EPS guidance to $3.20–$3.40.”104

Best Buy’s stock price declined from $41.70 to $35.52, a 14% decline.105

The defendants had not challenged market efficiency with respect to Best Buy stock; their argument with respect to lack of price impact was focused upon the event study of the plaintiff’s expert comparing the price at market close on September 13 with the closing price on September 14, when there was intervening, non-actionable information before the market opened on September 14 (the press release) that occurred before they supposedly made the misleading statements in the conference call. On the other hand, the event study of the expert witness for the defendants showed no price impact for the misleading statements.

The court, referring to the Seventh Circuit’s decision in Schleicher v. Wendt that, “when an unduly optimistic statement stops a price from declining . . . once the truth comes out, the price drops to where it would have been had the statement not been made,”106 responded:

The Court finds that Plaintiffs have made a sufficient showing that Best Buy’s stock price rose after the alleged misstatements and later declined after Best Buy revealed information on December 14, 2010.

100. Id. at *1 n.3, *2.
101. Id. at *1.
102. Id.
103. Id. at *1 n.2, *2.
104. Id. at *2 (citations omitted).
105. Id.
106. Schleicher v. Wendt, 618 F.3d 679, 683 (7th Cir. 2010).
Thus, Plaintiffs have made a sufficient showing that the alleged misrepresentations affected the market price of Best Buy stock, and the Court finds that Plaintiffs are entitled to the presumption of reliance.\textsuperscript{107}

More particularly, in concluding that the defendant’s evidence did not rebut the presumption of reliance, the court stated:

| The Court concludes that Defendants have not submitted evidence sufficient to rebut the presumption of reliance. The fact that non-actionable statements made in the press release may have caused initial upward movement in Best Buy’s stock price does not necessarily mean that misrepresentations made during the earnings conference call that occurred shortly thereafter did not also impact the stock price. Indeed, Plaintiffs allege that the stock price rose generally (if not in a straight line) throughout the class period, and then fell sharply after Best Buy revealed its true financial condition on December 13, 2010. (Even though the stock price may have been inflated prior to the earnings phone conference, the alleged misrepresentations could have further inflated the price, prolonged the inflation of the price, or slowed the rate of fall. This impact on the stock price can support a securities fraud claim.\textsuperscript{108} |

Because the defendants “ha[d] not offered evidence to show that Best Buy’s stock price did not decrease when the truth was revealed,” the court concluded “that Defendants ha[d] not submitted evidence sufficient to rebut the presumption of reliance.”\textsuperscript{109}

The Eleventh Circuit’s proposition in \textit{FindWhat} that securities liability can be premised upon “fraudulent misstatements that prolong [price] inflation,” which was relied upon in \textit{Best Buy}, predated \textit{Halliburton II} but was again followed after \textit{Halliburton II} in \textit{Local 703, I.B. of T. Grocery and Food Employees Welfare Fund v. Regions Financial Corp.}.\textsuperscript{110} This was the first court of appeals decision to deal

\textsuperscript{107} \textit{Best Buy}, 2014 WL 4746195, at *6.

\textsuperscript{108} \textit{Id.} at *6 (internal citation omitted) (citing \textit{FindWhat Investor Grp. v. FindWhat.com}, 658 F.3d 1282, 1315, 1317 (11th Cir. 2011)) (“[I]t is irrelevant to securities fraud liability that the stock price was already inflated before a defendant’s first actionable misrepresentation; fraudulent misstatements that prolong inflation can be just as harmful . . .”); \textit{In re Pfizer Inc. Sec. Litig.}, 936 F. Supp. 2d 252, 264 (S.D.N.Y. 2013) (“[A] misstatement may cause inflation simply by maintaining existing market expectations” (citation omitted)); see \textit{Schleicher}, 618 F.3d at 683–84 (explaining that a public misrepresentation may impact the stock price by causing the price to rise or stopping it from declining). “Moreover, price impact can be shown by a decrease in price following a revelation of the fraud.” \textit{Best Buy}, 2014 WL 4746195, at *6 (citing \textit{Schleicher}, 618 F.3d at 683–84).

\textsuperscript{109} \textit{Best Buy}, 2014 WL 4746195 at *6.

\textsuperscript{110} \textit{Local 703, I.B. of T. Grocery & Food Empls. Welfare Fund v. Regions Fin. Corp.}, 762 F.3d 1248, 1255 (11th Cir. 2014); \textit{FindWhat}, 658 F.3d at 1317; \textit{Best Buy}, 2014 WL 4746195, at
extensively with price impact after *Halliburton II*. The court, in dealing with price impact, looked at both the price rise accruing after the misrepresentation and the price drop occurring after the corrective statement. The case dealt with a situation in which the price was steadily dropping, a situation considered by the Seventh Circuit in the *Schleicher* case.

The Eleventh Circuit, in *Regions Financial*, first considered market efficiency and rejected the defendant’s argument that the district court certification was deficient because the lower court did not follow *Cammer v. Bloom*. The circuit court responded that the Eleventh Circuit had not adopted any mandatory test but had identified “some major, general characteristics”: “the market for a stock is generally efficient when ‘millions of shares change hands daily’” and there exists “‘a critical mass’ of investors and/or analysts who ‘study the available information and influence the stock price through trades and recommendations’.” In so doing, the court was not precluding the use of the *Cammer* factors, but merely rejecting them as a mandatory framework.

The court also recognized:

> However, even these 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. It is up to the District Courts to consider the nature of the market on a case-by-case basis to decide whether the totality of the circumstances supports a finding of market efficiency.

This is in line with *Halliburton II*’s recognition that the fraud-on-the-market presumption is based “on the fairly modest premise that ‘market professionals generally consider most publicly announced material statements about companies, thereby affecting stock market prices,’” and that *Basic* did not adopt “any particular theory of how quickly and completely publicly available information is reflected in market price.”

With respect to Regions Financial’s argument that it was always

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*6.

113. *Id.* at 1255.
115. *Id.* at 2410 (quoting *Basic, Inc. v. Levinson*, 485 U.S. 224, 248 n.28 (1988)).
necessary to require proof that the alleged misrepresentations had an immediate effect on the stock price, the Eleventh Circuit observed that the misleading statements were “confirmatory” statements that would not necessarily impact the price of the stock:

Confirmatory misrepresentations “confirm” existing information about a stock, rather than release new and different information that might bring about a negative change in the stock’s price. In other words, Regions’s disclosures were designed to prevent a more precipitous decline in the stock’s price, not bring about any change to it. When a company releases expected information, truthful or otherwise, the efficient market hypothesis underlying Basic predicts that the disclosure will cause no significant change in the price.116

In so doing, the circuit court referred to FindWhat: “A corollary of the efficient market hypothesis is that disclosure of confirmatory information—or information already known by the market—will not cause a change in the stock price. This is so because the market has already digested that information and incorporated it into the price.”117

The court also noted that: “[A] confirmatory misrepresentation is like an omission, because it is an affirmative representation that omits negative information. Thus, like we do here, the District Court noted that this type of misrepresentation would likely yield price stability rather than volatility, just as we would expect with a traditional omission.”118

The Eleventh Circuit found the necessary price impact for the plaintiffs’ to meet their initial burden under Basic in the market reaction to the corrective disclosure:

The plaintiffs in this case did identify one unexpected disclosure around the class period—a corrective disclosure on January 20, 2009, which had an immediate negative impact on the stock price. On this record, the District Court did not abuse its discretion when it refused to require the plaintiffs to identify more instances of unexpected disclosures and a resulting price impact before finding the initial burden under Basic satisfied.119

However, according to the Eleventh Circuit, while Regions Financial presented evidence on price impact, the district court did not fully consider such evidence and, in light of Halliburton II, the case was

116. Regions Fin. Grp., 762 F.3d at 1256 (citations omitted).
117. Id. (quoting FindWhat, 658 F.3d at 1310).
118. Id. at 1256 n.5.
119. Id. at 1257.
remanded for reconsideration. In so doing, the Eleventh Circuit signaled that price impact need not be found both at the time of the misrepresentation and upon the corrective disclosure: "Halliburton II by no means holds that in every case in which such evidence is presented, the presumption will always be defeated. Indeed, this Court has recognized the distinct role that confirmatory information may have in this analysis."

Upon remand, the district court both considered whether or not there was price impact and also summarily disposed of defendants’ arguments with respect to materiality and loss causation, issues which the Supreme Court has held are reserved for the trial on the merits. With respect to the defendants’ argument that ‘none of the misrepresentations were material because the marked [sic] price never reflected the misrepresentations,’ the court responded: "Defendants mix price impact and loss causation. Proof of the cause of plaintiff’s losses as a result of the defendants’ misrepresentations is not before the court at this time. Such a discussion is in the realm of ‘‘loss causation’’ and reserved for a trial on the merits.” With respect to materiality, defendants also argued:

[N]one of the misrepresentations identified by the plaintiffs were, in fact, material, because the market was already aware that the statements were false. Additionally, defendants claimed that misrepresentations from April 2008 through January 2009 were immaterial, because the market was aware the loan loss reserves were going to increase.

This argument is akin to the “truth-on-the-market” defense, which the district court, relying upon Aranaz v. Catalyst Pharmaceutical Partners, rejected.

120. Id. at 1258–59.
121. Id. at 1259. The court cited FindWhat, noting that “A corollary of the efficient market hypothesis is that disclosure of confirmatory information—or information already known by the market—will not cause a change in the stock price. This is so because the market has already digested that information and incorporated it into the price.” Id. (citing FindWhat, 658 F.3d at 1310).
122. See generally Amgen Inc. v. Conn. Ret. Plans & Trust Funds, 133 S. Ct. 1184 (2013) (noting that proof of materiality of alleged misrepresentations are not a prerequisite to a class); Erica P. John Fund, Inc. v. Halliburton Co. (Halliburton I), 131 S. Ct. 2179 (2011) (holding that plaintiffs need not prove loss causation in order to obtain class certification).
124. Id.
125. Id. at *7.
The Significance and Impact of Price Distortion

Turning to price impact, the focus of the district court was upon the price impact of the corrective disclosure. With respect to the lack of price impact from the fraudulent confirmatory disclosures, the court stated that “[c]learly, representing Regions had assets that did not actually exist could keep the value of its stock trading at artificially high level.”

With respect to the corrective announcement on January 20, 2009 that the company had suffered a $5.6 billion loss for the fourth quarter of 2008 (driven by the net loss of $6 billion charge for the impairment of goodwill), the defendants acknowledged that Regions Financial stock “fell to $4.60, a drop of $1.40,” or about 24.2%. But the defendants explained this drop as follows: “Defendants’ expert asserts that the January 20, 2009, price tumble was based on external market factors, citing to evidence that on the same date, January 20, 2009, Wells Fargo stock fell 23.89 percent, BB & T stock fell 11.09 percent, and Huntington Bancshares fell 16.45 percent.”

The district court did not find this persuasive:

Yet those same evidentiary submissions noted such reports from industry analysts as that, on January 21, 2009, “Regions took a goodwill impairment in 4Q08, driving a high GAAP loss per share of $9.01. The goodwill impairment accounted for $8.66 of the loss.”

This, of course, is evidence of price impact.

In addition, the defendants’ event study “also noted that the New York Stock Exchange index declined only 6.11 percent that same day.” This served to rebut the defendants’ argument that the decline in Regions’ stock was due to “across-the-board investor panic.”

Consequently, the defendants failed to establish a lack of price impact. The court rejected the defendants’ argument that, “because plaintiffs’ expert conducted no event study of his own, plaintiffs necessarily cannot survive the analysis after Halliburton II.” Factors that appear to militate against defendants were that the NYSE index dropped only 6.1% on the day that Regions Financial stock dropped 24% and that one analyst focused upon the goodwill impairment in his

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127. Regions Fin. Grp., 2014 WL 6661918, at *7 (“Using misrepresentations to maintain a stock price is no less of a fraud than the use of the same to artificially increase the price.”).
128. Id.
129. Id.
130. Id. (internal citation omitted).
131. Id. at *8.
132. Id.
133. Id.
report. On the other hand, another financial institution, Wells Fargo, also fell about 24%. However, from the opinion, we do not know whether comparable negative information was also made available to the market about Wells Fargo. In addition, the disclosure of overstated assets and inadequate reserves by one financial institution may have indicated to the market that other financial institutions had similar problems.

In determining that the defendants had not established a lack of market impact, the district court was quite clear that it saw its role as not conducting an extensive mini-trial on this issue:

Regardless of other events occurring the day in question, defendants concede its stock tumbled 24% on January 24, 2009. Whether this tumble was due to defendants’ corrective disclosures, namely that good will was significantly more impaired than previously asserted and that the loan loss reserves where drastically understated, or due to the overall market conditions on that day, is an ultimate question in this action, and properly reserved for a jury to decide. Similarly, whether this tumble was the continuation of the steady decline in stock price from February 2008 through the end of the class period, due to external market factors, or whether it was directly attributable to the January 20, 2009, corrective disclosure is a question of fact, so tied to the merits of this case that it is reserved for the trier of fact.134

This approach by the district court avoided raising the Seventh Amendment issue that could occur when a district court decides disputed evidentiary issues at a mini-trial at certification, thereby depriving plaintiff of a jury trial on such disputed facts.135

The fourth case, Aranaz v. Catalyst Pharmaceutical Partners,136 applied a rigorous standard in evaluating whether defendants had established the absence of price impact. There, the defendants issued a press release on August 27, 2013 stating that “a Catalyst drug named Firdapse, which treats Lambert–Eaton Myasthenic Syndrome (“LEMS”), had been designated by the Food and Drug Administration (“FDA”) as a Breakthrough Therapy and that there was no effective and available treatment for LEMS.”137 After the release, the price of

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134. Id.
137. Id. at 662.
Catalyst common stock increased 42%, from $1.42 to $2.01.\textsuperscript{138} Two and one-half months later, on October 18, 2013, an article was published that reported “Amifampridine (“3,4–DAP”) was an effective treatment for LEMS, had been available for years and was nearly identical to Firdapse.”\textsuperscript{139} Moreover, the article reported that Amifampridine was offered to LEMS patients free of charge.\textsuperscript{140} The price of Catalyst common stock dropped from $2.61 to $1.90 on October 18, and then to $1.52 the following day.\textsuperscript{141} This was a 42% decrease in the price of Catalyst stock.

According to the district court in Catalyst, “once a plaintiff shows entitlement to a presumption of reliance, the defendant is burdened with the daunting task of proving that the publicly known statement had no price impact.”\textsuperscript{142} As the following analysis of the court’s examination of the defendants’ arguments will demonstrate, the defendants’ task is indeed “daunting.”

The defendants sought to explain the 42% increase in the price on the basis that other information in the release, namely the designation as a “breakthrough therapy,” was the factor that drove the price increase.\textsuperscript{143} This was certainly a significant factor since it would provide expedited development and review of the drug. In addition:

According to Defendants, the relative importance of Firdapse’s Breakthrough Therapy status is buttressed by the fact that: (1) both financial analyst reports issued following the press release focused on Firdapse’s Breakthrough Therapy status and both ignored the alleged misrepresentation; (2) one financial analyst raised its target price for Catalyst common stock following the press release and explicitly credited this change to Firdapse’s being designated as a Breakthrough Therapy; and (3) articles published in news outlets following the press release focused on Firdapse’s Breakthrough Therapy status.\textsuperscript{144}

However, the district court determined that the foregoing did not establish a lack of price impact: “But even assuming arguendo that the announcement of Firdapse’s Breakthrough Therapy designation was

\begin{itemize}
\item \textsuperscript{138} Id.
\item \textsuperscript{139} Id.
\item \textsuperscript{140} Id.
\item \textsuperscript{141} Id.
\item \textsuperscript{142} Id. at 673 (“[T]he Court recognizes that it is incumbent upon the defendant to show the absence of price impact. The Court’s judgment, therefore, should impose no heavy toll on securities-fraud plaintiffs with tenable claims.” (quoting Halliburton Co. v. Erica P. John Fund, Inc. (\textit{Halliburton II}), 573 U.S. —, 134 S. Ct. 2398, 2417 (2014) (Ginsburg J., concurring))).
\item \textsuperscript{143} Id. at 669.
\item \textsuperscript{144} Id. at 672.
\end{itemize}
substantially more important than the alleged misrepresentation that there existed no effective and available treatment for LEMS, it does not follow that the misrepresentation did not account for any of the 42% spike in stock price.”145

The district court then considered the defendants’ arguments that the “corrective” disclosure that there was an alternative treatment for LEMS did not account for the 42% price drop. According to the defendants, “bad publicity and market overreaction from the October 18, 2013, article fully accounted for the 42% decline in stock price.”146 The court determined that this argument also failed:

While the article painted Catalyst as a villain for its plan to charge for Firdapse notwithstanding that LEMS patients had effectively been receiving the drug free of charge, and while bad press and market overreaction may have affected Catalyst’s stock price, it does not follow that the revelation of 3,4–DAP as an effective and available alternative to Firdapse did not also contribute to the 42% fall in stock price.147

According to the court, showing that one factor may have contributed to the price drop did not mean that another factor did not also contribute:

Thus, notwithstanding that the commentary following the article focused on Catalyst’s greed, and notwithstanding that the article did not cause any analysts to lower their target price of Catalyst stock, Defendants have not shown that the revelation of 3,4–DAP as an effective and available alternative to Firdapse had no negative impact on the price of Catalyst stock.148

The court supported its conclusion that market overreaction was not the sole cause of the price drop by noting that the “the price of Catalyst stock did not recover in the days or months following the publication of the article.”149

The defendants also offered expert testimony that “the increase in Catalyst’s market capitalization immediately following the press release is ‘fully consistent’ with the rise in market capitalization of the twenty-two other companies that have announced Breakthrough Therapy designation.”150 The court questioned the relevance of this analysis as it related to whether the alleged misrepresentation had a price impact

145. Id.
146. Id.
147. Id.
148. Id.
149. Id. at 672 n.5.
150. Id.
and, more significantly, stated that demonstrating “that an absence of price impact is consistent with their analysis was insufficient.”

Because Defendants have the burden of showing an absence of price impact, they must show that price impact [regarding the alleged fraudulent statement] is inconsistent with the results of their analysis. [Consequently] Defendants fail[ed] to show that the alleged misrepresentation did not at all contribute to the 42% spike in the price of Catalyst common stock on August 27, 2013.152

The district court placed a further burden upon defendants:

[A]ssuming arguendo that Defendants had shown the August 27, 2013, price spike to be wholly caused by the truthful announcement of Firdapse’s Breakthrough Therapy designation, it is still possible that the alleged misrepresentation offset some unexpected event or information that would have negated to some extent the market effect of Breakthrough Therapy status. [Defendants did not] even attempt to show that there were no unexpected events negatively affecting Catalyst’s stock price on August 27, 2013. And by failing to show an absence of these other factors, which might have been offset by the alleged misrepresentation, Defendants fail to show an absence of price impact.153

The foregoing analysis by the district court supports Justice Ginsburg’s conclusion in her concurring opinion that Halliburton II “should impose no heavy toll on securities-fraud plaintiffs with tenable claims.”154

CONCLUSION

From the foregoing cases and analyses, the following conclusions can be drawn:

First, litigating a general proposition as to whether a particular company’s stock traded in an efficient market involves futility and irrelevancy, as well as undue cost and waste of judicial resources. What is relevant is the specific issue of whether a misrepresentation involved price distortion.

Second, where the misleading statements are confirmatory, price distortion is established not by price movement at the time of the misrepresentation, but rather when the corrective disclosure is made.
Third, if a defendant seeks to defeat certification by showing a lack of price impact, the defendant must negate any price impact from the misrepresentation. Otherwise, the district court is summarily making a determination of a disputed factual issue, thus interfering with the plaintiff’s Seventh Amendment right to have a jury trial on the merits.

Fourth, if a court does conduct an evidentiary mini-trial on price impact, the court must permit extensive discovery and opportunity for plaintiff to rebut the lack of price impact. Consequently, the determination by the court on this issue should either be the law of the case or should have issue preclusion effect.

Fifth, under the circumstances in the preceding fourth paragraph, the Seventh Amendment right of the plaintiff to a jury trial is clearly violated. The determination of a lack of price impact is dispositive of the case and involves a disputed factual determination outside the trial on the merits.

Consequently, certification should not resolve contested issues of fact but should be solely procedural in nature. The most sound way to accomplish this would be to recognize that what the market, and investors in the market, rely upon is a total mix of information in the market, that price is derived from that information, and that, by corporate management inserting misleading information into the market, they have provided a normative basis for reliance by investors generally. Certification should be a summary procedure and disputed factual issues—such as materiality, loss causation, and price impact—should be resolved at a trial on the merits. Judicial time and expense should not be wasted on trying to determine the concept of market efficiency, a matter upon which economists do not even agree.