Halliburton II And The Importance Of Economic Analysis Prior To Class Certification

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On June 23, 2014, the U.S. Supreme Court handed down its long-awaited decision in *Halliburton Co. v. Erica P. John Fund*.[1] The ruling affirms *Basic Inc. v. Levinson*,[2] but finds that defendants can introduce a direct price impact analysis prior to class certification.

In *Basic* the Supreme Court held that investors could meet the reliance requirement in a securities fraud class action indirectly, by demonstrating market efficiency and invoking a rebuttable presumption of reliance based on the "fraud on the market" theory—a theory holding that "the market price of shares traded on well-developed markets reflects all publicly available information, and, hence, any material misrepresentations." In *Halliburton II*, the Court declined to overturn *Basic*. It did find, however, that in cases where plaintiffs met their burden of proving market efficiency, defendants could rebut this presumption prior to class certification by showing direct evidence "that the alleged misrepresentation did not actually affect the stock price – that is, that it had no 'price impact.'"

In essence, *Halliburton II* continues to allow plaintiffs to prove price impact indirectly and broadens the scope of evidence that courts must consider at the class certification stage to include direct evidence refuting price impact:

> *Basic* allows plaintiffs to establish price impact indirectly, by showing that a stock traded in an efficient market and that a defendant's misrepresentations were public and material. But an indirect proxy should not preclude consideration of a defendant's direct, more salient evidence showing that an alleged misrepresentation did not actually affect the stock's price and, consequently, that the *Basic* presumption does not apply.

Event Studies

Halliburton II states that in order to show indirectly that the presumption of reliance holds in a given case, a plaintiff must demonstrate that the stock traded in an efficient market, among other things. Event studies have long played a significant role in assessing market efficiency. Going forward, they (along with other economic analysis) will also be key tools for defendants seeking to establish prior to class certification that an alleged misrepresentation did *not* impact price.

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Over the past forty years, academic research in finance and accounting has utilized and refined event study methodology. An event study is now commonly used by financial economists and is a widely accepted methodology that provides an objective measure of whether there has been a significant change in stock price.

The standard event study approach employed in securities fraud class actions uses the statistical method of regression to account for market and industry effects. Because stock prices reflect market-, industry-, and company-specific information, it is necessary to extract the market- and industry-specific portions of stock price changes to isolate the change that may be related to company-specific information. Once market and industry effects are controlled for within the statistical model, standard statistical tests are conducted on the remaining or "residual" stock price change to determine if each daily change is statistically different from normal random price movements, or "statistically significant." Price movements that are not statistically significant cannot be reliably distinguished from statistical noise and cannot be attributed to a particular piece of information within the statistical model.

Direct Price Impact Analysis

Event studies are an important tool in the financial economists' portfolio for determining whether an alleged misrepresentation affected stock price. In order to assess the price impact (if any) of an alleged misrepresentation, it may be useful to employ an event study to examine either contemporaneous stock price movements (front end) or stock price movements at the time of an alleged corrective disclosure (back end) – or both.

Using event studies to measure price impact on the front end. The lack of a statistically significant residual stock price change at the time of an alleged misrepresentation indicates no significant change in the total mix of information regarding a company at that time. Such a finding is consistent with a conclusion that the alleged misrepresentation did not impact price.

In cases where the alleged misrepresentation comprises an omission, event study findings at the front end are not relevant. An event study only measures stock price reaction to information that was actually disclosed, and cannot measure the impact of information that was *not* disclosed. In such cases, a different analysis would be required to establish lack of price impact, such as looking at back-end price reaction when the alleged truth is revealed, or building a fundamental valuation model. Both are discussed further below.

In cases where the alleged misrepresentation is an affirmative misstatement, an event study may establish that the alleged misrepresentation did not impact stock price at the time it was made. In many instances, however, analysis in addition to an event study may be required because an event study measures only the net stock price impact of all simultaneously released information, and only rarely is an alleged misrepresentation made in isolation. It is only infrequently the case that the alleged truth was "A" and the defendant said "not A" and only "not A" (i.e., no additional news was provided at the time of the alleged misrepresentation). When other news is announced simultaneously, a financial economist would need to perform analysis to assess the stock price impact of that other news in order to isolate the price impact (if any) of the alleged misrepresentation.

Using event studies to measure price impact on the back end. The lack of a statistically significant stock price change at the time that an alleged misrepresentation is corrected indicates no change in the total mix of public information at that time. Such a finding is consistent with a conclusion that the alleged misrepresentation did not impact price when it was made.

Again, analysis in addition to an event study may be required in order to assess the price impact (if any) of the alleged misrepresentation when it was made under certain circumstances. For example, when other news is announced at the same time as the corrective information, an economist would need to perform analysis to assess the stock price impact of that other news. Moreover, if market, industry, or company conditions have changed substantially since the time of the alleged misrepresentation, an economist would need to assess the stock price impact of those changes. For example, a company's stock price may react more negatively to a minor EBITDA (earnings before interest, taxes, depreciation, and amortization) forecast miss when the company is close to violating an EBITDA debt covenant than it would when there is a significant cushion. An economist might need to account for such changes in his or her assessment of price impact.

Additional analyses for assessing price impact. In cases when an event study is not itself sufficient to establish the lack of price impact, other important economic tools may be useful. For example, review of investment analyst reports may provide insight into what importance (if any) financial professionals assign to the alleged misrepresentation or correction. Fundamental financial analysis—for example, constructing a discounted cash flow model – may also be relevant. A company's stock price reflects market consensus regarding the value of future cash flows to its stockholders. Fundamental financial analysis can be useful to assess what impact (if any) the alleged misrepresentation would have on expected future cash flows or discount rate, and hence stock price.

Conclusion

Halliburton II reiterates the Supreme Court's holding in *Basic* that "[a]ny showing that severs the link between the alleged misrepresentation and either the price received (or paid) by the plaintiff, or his decision to trade at a fair market price, will be sufficient to rebut the presumption of reliance." The Supreme Court's recent decision establishes another avenue for this prior to class certification – namely, direct evidence that the alleged misrepresentation did not impact price. While the ruling does not provide specific guidance regarding precisely what evidence will be required to sever the link, it does refer to an event study as a possible method for showing that the alleged misrepresentation had no price impact.

Given the new avenue for opposing class certification, the prominence of economic analysis, including event studies, may increase in this early stage of litigation. Analyzing the price impact (if any) of an alleged misrepresentation is not new to securities fraud class actions. It has long been an important part of the merits phase of the case, playing an integral role in the assessment of damages, loss causation, and materiality. However, the Supreme Court's ruling in *Halliburton II* could well accelerate the demand for rigorous economic analysis related to the price impact (if any) of an alleged misrepresentation, providing defendants an additional way to truncate a case if they can meet the burden of showing that the alleged misrepresentation did not impact price.

The views in this article are solely those of the authors, who are responsible for the content, and do not necessarily represent the views of Cornerstone Research.

1. *Halliburton Co. v. Erica P. John Fund Inc.*, 573 U.S. ___ (2014) (*Halliburton II*).
2. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988) (*Basic*).

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