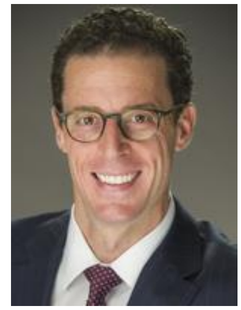
An Analytical Approach To Defending Securities Class Claims

By **Nessim Mezrahi**



Nessim Mezrahi

Since the event-driven securities class action lawsuit against PG&E Corporation was filed one year ago, plaintiffs counsel have filed 211 securities class action complaints that allege violations of the federal securities laws under Section 10(b) and 20(a) of the Securities Exchange Act of 1934 against U.S.-based public corporations.[1] During the preceding 12 months, 59 of the 211 class action complaints that allege violations of Rule 10b-5 have been filed against a defendant company that had already been sued for similar allegations of fraud on the market.

A price impact analysis of the 152 first-identified securities class action complaints against directors and officers of U.S.-based corporations, indicates that a total of 264 alleged stock price declines are related with corrective disclosures that claim to be rectifying the corresponding alleged misstatements or omissions.[2] Of the 264 alleged corrective disclosures presented in 152 securities class action complaints, damages claimed by shareholders of common stock on 41 stock price declines do not meet the threshold of indirect price impact to warrant class action treatment according to the U.S. District Court for the Northern District of Texas' 2015 ruling in Erica P. John Fund Inc. v. Halliburton Co.[3]

The claimed market capitalization losses associated with the cohort of alleged stock price declines that exhibit a verifiable absence of indirect price impact at the 95% confidence standard, amounts to $36.8 billion.[4] Data and analysis indicate that 33 securities class action complaints filed in the last 12 months contain at least one alleged stock price drop that does not surpass the standards of indirect price impact. Data and analysis indicate that 14 securities class action complaints do not present any alleged corrective disclosures related with stock price declines that exhibit indirect price impact. The alleged market capitalization losses of the 14 securities class actions that present alleged stock price drops that do not surpass the standards of indirect price impact at the 95% confidence standard, amounts to $11.1 billion.

In securities class actions, the quantum of aggregate damages is driven primarily by stock price impact at the time of the alleged corrective disclosure. Basically, the severity of the claim is driven by the volume of shares that is sold during a single trading session in response to public information that allegedly rectifies a related misstatement or omission. "Price impact is thus an essential precondition for any Rule 10b-5 class action."[5] Ongoing econometric analyses of price impact using comprehensive statistical techniques of event-study analysis indicate that verifiable evidence of an absence of price impact exists in approximately 16% of alleged corrective disclosures claimed over the preceding 12 months.[6]

Indirect price impact, also referred to as back-end price impact, is evaluated by analyzing the magnitude of the stock price decline that corresponds with the timing of the dissemination of the information that is claimed to be correcting a related misstatement or omission. The allegedly rectifying decline in stock price has to fully materialize over a single trading session. "[T]he use of a two-day window is inappropriate to measure price impact in an efficient market."[7] At the 95% confidence standard, after statistically controlling for general stock market and industry-specific factors, the aforementioned sample of 41 claimed corrective stock price declines do not warrant inclusion in a potentially certified class based on Halliburton II (2014), and do not deserve attribution of potential aggregate damages according to heightened pleading standards of loss causation in Dura (2005).[8]

The econometric evaluation of indirect price impact earlier in the litigation life cycle has cost-saving benefits for insurers of directors and officers. "Defendants may seek to defeat the Basic presumption at that stage through direct as well as indirect price impact evidence."[9] If there is verifiable absence of indirect price impact in a securities class action complaint, then directors and officers ought to expect an efficient and successful defense that negates class action treatment. For example, "the court agrees with Halliburton that there was no price impact on December 21, 2000, and finds that Defendants have rebutted the Basic presumption as to the allegedly corrective disclosure made on that date."[10]

There is no doubt that class action treatment has lucrative benefits for both defense and plaintiffs counsel — "half of the nearly $23 billion in securities claims costs in the last five years has gone to plaintiff and defense lawyers."[11] Considerable economic and emotional relief will be gained by directors and officers of publicly traded companies from knowing that the claims of alleged securities fraud that have been filed against them do not warrant class action treatment. The absence of econometric validity of indirect price impact is critical to prevent class certification of a filed claim for alleged violations of section 10(b) and 20(a) of the Securities Exchange Act.

The econometric analysis of indirect price impact is vital early in the litigation life cycle to more accurately estimate the claim's severity. At a portfolio level, insurers of directors and officers can estimate a narrower range of capital outlay for these long-tail claims with econometric information that proves the absence of indirect price impact. However — even if class action treatment is denied — directors and officers may still face similar claims of securities fraud allegations from an opt-out plaintiff. Some of these direct-action cases have settled for substantial amounts that rival those attained in class actions.[12]

Analysis of direct price impact, also known as front-end price impact, is crucial after a securities class action survives the motion to dismiss. Upon survival, defense counsel and their testifying economists evaluate stock price movement at the time of the alleged misstatement.[13]

In preparation for class certification, defense counsel carries the pricey and heavy burden of testing the strength of relatedness between an alleged misrepresentation and the allegedly related corrective disclosure. A comprehensive and timely analysis that evaluates whether the information that encompasses a claimed corrective disclosure is in fact corrective of a related alleged misstatement is not required at the class certification stage.[14] The effect that any absence of direct price impact has on the evolution of the securities class action is heavily dependent on whether the plaintiffs' theory of securities fraud relies on an artificially maintained stock price.

> If a particular disclosure causes the stock price to decline at the time of the disclosure, then the misrepresentation must have made the price higher than it would have otherwise been without the misrepresentation. Measuring price change at the time of the corrective disclosure, allows for the fact that many alleged misrepresentations conceal a truth. Thus, the misrepresentation will not have changed the share price at the time it was made.[15]

On these types of cases, lead counsel will attempt to establish that some portion of stock price decline during the corresponding trading session constitutes a dissipation of inflation that is claimed to have artificially maintained the market value of the defendant company. Lead counsel will also attempt to establish that directors and officers had the mindset to willingly perform an illicit action without disclosing it, and as a result the company was trading at an artificially maintained market value that is alleged to be unsupported by its business operations.

Based on this legal theory of "artificial price maintenance," an unremarkable stock price appreciation on the date of the alleged misstatement or omission is insufficient to rebut the presumption of reliance under the fraud-on-the-market doctrine. That is a serious risk for directors and officers that are navigating uncertain market conditions.

> Lack of price movement on dates of alleged misrepresentations did not rebut presumption of reliance on misrepresentations based upon fraud on the market theory by preponderance of evidence on investors' motion for class certification in securities fraud action against financial services provider on price maintenance theory alleging violations of § 10(b) … [16]

The absence of direct price impact has debilitating consequences for plaintiffs counsel that file a securities class action that does not allege an "artificial price maintenance" theory, but not nearly as terminal as the absence of indirect price impact as it relates to attaining class certification and the limitation of potential aggregate damages. For the purpose of simplicity, assume that a securities class action has a single alleged corrective disclosure and that stock price did in fact appreciate at the time when the allegedly related misrepresentation was made to participants in the market — but, there is an unremarkable stock price decline at the time when plaintiffs allege some (or all) information that was released corrected that misrepresentation. It would be notably uncommon if this case survived a motion to dismiss and required significant resources to negate class certification.

> [T]here is no period within the proposed class period where the alleged misrepresentation caused a statistically significant increase in the price or where a corrective disclosure caused a statistically significant decline in the price. Thus, the reliance presumption of the class as Lead Plaintiffs have defined it is successfully rebutted and the class cannot be certified.[17]

The analysis of direct price impact is complex and highly involved. Therefore, it makes economic sense for protectors of directors and officers of publicly traded companies to ascertain whether there is verifiable proof that demonstrates an absence of indirect price impact, first. Econometric analysis of indirect price impact provides transparency into the economic merits of a securities class action claim and separates the wheat from the chaff. The identification of material econometric weaknesses of price impact in an Exchange Act claim for alleged violations of Rule 10b-5 can prevent class action treatment to limit the costs of securities class actions.

Nessim Mezrahi is co-founder and CEO of SAR LLC, a securities class action data analytics software company.

[1] In Re PG&E Corporation Securities Litigation

[2] SAR Securities Class Action Data Analytics (SCADA) database as of June 12, 2019. These estimates exclude cases that have been voluntarily dismissed. The sample of alleged corrective disclosures that has been tested for indirect price impact includes only claimed stock drops that have been identified in a first-identified complaint filed during the preceding twelve months against a U.S.-based company that has publicly traded shares of common stock in the NYSE or NASDAQ.

[3] Erica P. John Fund, Inc. v. Halliburton Co., 309 F.R.D. 251 (N.D. Tex. 2015).

[4] Freedman, David A., and David H. Kaye, "Reference Guide on Statistics," Reference Manual on Scientific Evidence (Washington D.C.: Federal Judicial Center, 3rd ed., 2011).

[5] Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014).

[6] SAR Securities Class Action Data Analytics (SCADA) database as of June 12, 2019.

[7] Erica P. John Fund, Inc. v. Halliburton Co., 309 F.R.D. 251 (N.D. Tex. 2015).

[8] Dura Pharmaceuticals, Inc. v. Broudo, No. 03-932, 2005 WL 885109 (U.S. April 19, 2005).

[9] Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014).

[10] Erica P. John Fund, Inc. v. Halliburton Co., 309 F.R.D. 251 (N.D. Tex. 2015).

[11] From Nuisance to Menace: The Rising Tide of Securities Class Action Litigation, Chubb, June 2019.

[12] Vanguard Specialized Funds v. VEREIT Incorporated (D. Ariz. 2016)

[13] Waggoner v. Barclays PLC, 875 F. 3d 79

[14] Halliburton Co. v. Erica P. John Fund, Inc., 134 S. Ct. 2398 (2014).

[15] Erica P. John Fund, Inc. v. Halliburton Co., 309 F.R.D. 251 (N.D. Tex. 2015).

[16] Waggoner v. Barclays PLC, 875 F. 3d 79

[17] In re Moody's Corp. Securities Litigation 274 F.R.D. 480 (S.D.N.Y. 2011)

THIS ARTICLE FIRST APPEARED ON LAW360.COM