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Halliburton v. Erica P. John Fund: Potential impacts on expert analysis

Oral arguments before the Supreme Court in *Halliburton v. Erica P. John Fund* have led to extensive analysis and commentary.[1] The questions presented are:

- Whether the Court should overrule or substantially modify the holding of *Basic Inc. v. Levinson*, 485 U.S. 224 (1988), to the extent that it recognizes a presumption of classwide reliance derived from the fraud-on-the-market theory.
- Whether, in a case where the plaintiff invokes the presumption of reliance to seek class certification, the defendant may rebut the presumption and prevent class certification by introducing evidence that the alleged misrepresentations did not distort the market price of its stock.[2]

The case has been viewed with great interest because of its potential impact on securities class action litigation. More than 20 amicus briefs were filed in advance of oral arguments.[3] Among these briefs, the "Brief for Law Professors in Support of Petitioners" (law professors' brief), was discussed during oral arguments and according to analysts, indicative of a potential "midway position."[4]

In this note we consider potential impacts from the Court's eventual ruling in *Halliburton*.

Potential impacts of the eventual ruling

Predictions of the potential impact of the Court's eventual ruling have ranged from no change if *Basic* is affirmed, to an end to securities class actions if overturned. A "midway" outcome, requiring assessment of price impact at the class certification stage, would likely have a substantial impact on the nature and extent of expert testimony at the class certification stage.

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[1] *See* Alison Frankel, "At Halliburton argument, Justices show little appetite for killing Basic," *Reuters,* March 4, 2014, accessed April 2, 2014, http://blogs.reuters.com/alison-frankel/2014/03/05/at-halliburton-argument-justices-show-little-appetite-for-killing-basic/. *Halliburton Co., et al. v Erica P John Fund, Inc. FKA Archdiocese of Milwaukee Supporting Fund, Inc*., Docket No. 13-317, March 5, 2014, at 1–55, available at http://www.supremecourt.gov/oral_arguments/argument_transcripts/13-317_7n5f.pdf.

[2] *See Halliburton*, 718 F 3d 423, November 13, 2013, http://www.supremecourt.gov/qp/13-00317qp.pdf.

[3] *See* American Bar Association, "Preview of United States Supreme Court Cases," *Halliburton v. Erica P. John Fund, Inc.,* Docket No. 13-27, http://www.americanbar.org/publications/preview_home/13-317.html.

[4] Amici include Adam C. Pritchard (University of Michigan Law School) and M. Todd Henderson (University of Chicago Law School). Brief of Law Professor as Amici Curiae in Support of Petitioners, *Halliburton v. Erica P. John Fund*, 13-317, January 2014. The phrase "midway position" is used by Justice Kennedy at line 12, page 17 of the transcript.

Price impact

The law professors' brief argues that a generalized finding of market efficiency is not a necessary requirement to support a fraud on the market presumption. The brief suggests that showing generalized market efficiency may be appropriately replaced by a demonstration that a specific misstatement had a price impact. Focusing on price impact avoids challenges created by empirical research asserting limitations of the efficient markets hypothesis and reduces the difficulty for courts in determining whether a particular market is adequately efficient through the use of measures such as the *Cammer* criteria.[5]

> Event studies do not prove specific information caused a security's price to change; rather, they rule out alternative explanations so that causality can be reasonably inferred.

Instead of a generalized test of market efficiency at the class certification stage, the law professors argue in favor of determining whether the specific alleged misrepresentation affected the price of the security through the use of an event study. That is, economic analysis would be used to show that a misrepresentation affected stock price, rather than applying a presumption that it affected stock price given a more generalized finding that a security traded in an efficient market.

Expanded role of the expert and use of an event study at class certification

Event studies can be complex undertakings, and have been common fixtures at the merits stage of securities matters. However, event studies do not prove specific information caused a security's price to change. Instead, the event study method seeks to rule out alternative explanations for observed price changes (i.e., random fluctuations, market-wide effects, and confounding information) so that causality can reasonably be inferred. The discussion in the oral argument transcript debated how much, if any, of that analysis ought to be moved to the class certification stage.

Implications for expert analysis

If the Court rules in favor of an approach focused on price impact, one would expect a heightened focus on expert analysis at the class certification stage. Cases where market efficiency might otherwise be difficult to contest (e.g., NYSE-traded stocks) might face heightened disputes over price impact analysis. A focus on testing price impact raises a number of important issues with respect to the use of an event study at the class certification stage. Application of an event study to the price impact question will not result in a simple set of rules, but would likely require expert judgment and analysis.

Assessing price impact over the alleged class period

An event study of a misstatements price impact narrowly focuses on either the date an alleged misstatement is made or the date the truth is disclosed. If a misstatement is found to have a price impact on one date, expert judgment and analysis may still be needed to determine whether the same misstatement would have a price impact on other dates during the class period. Such a determination will vary with the type of information misstated, the type of security at issue, and how the total mix of information affecting that security's price changed over time.

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[5] *Cammer v. Bloom* identified five indicators of market efficiency including trading volume, number of analysts, existence of market makers/arbitrageurs, eligibility to file S-3 registration statement, and empirical facts showing a cause-and-effect relation between news and securities prices.

Evaluating over- and under-reactions

It is not uncommon for securities prices to appear to exhibit over- or under-reaction to new information over a short time period. This might reflect, for example, the speed of information dissemination, the complexity of the information, or simply illiquidity in a particular market. For example, an alleged misstatement may appear to have a price impact on a one-day basis, but not on a two-day basis. In such situations, expert judgment and analysis is needed to define the appropriate time window to conduct statistical tests and determine whether any apparent bounce-back in price is related to an alleged misstatement.

Controlling for confounding factors

To provide conclusive evidence of the price impact of an alleged misstatement, experts must assess the price impact of confounded events – other information potentially affecting price at the same time as the misstatement being tested. Depending on the nature of the confounding information, there may be imprecision in an expert's ability to control for confounding information. The margin of error in such analyses might be the difference between showing whether a misstatement has a price impact or not.

Application of an event study to the price impact question will not result in a simple set of rules, but would likely require expert judgment and analysis.

Controlling for industry effects on stock price

Event studies commonly attempt to control for market and industry effects by measuring the average response of a security to changes in market and industry benchmark indices. This relationship can break down when considering specific events or narrow windows of time. While a stock might move in lockstep with its industry peers on average, there may be times when the stock moves in an opposite direction.[6]

Statistical tests

When there is apparent price impact, statistical tests are applied to determine if a change in securities price was significant when compared to normal variability in that security's price. If statistical significance is required in the assessment of price impact, properly defining the statistical test of significance typically requires expert judgment and analysis.

Conclusion

Event studies require expert analysis and judgment, particularly when they are narrowly focused on one or a few events. Expert judgment takes on a more important role at the class certification stage if the Court implements an approach requiring the demonstration of price impact through an event study.

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[6] For example, information affecting product demand may cause industry peer stock prices to move in the same direction. Information affecting the relative positioning of competing firms may cause their respective stock prices to move in opposite directions.

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