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Q2 Stock Drop Stats Buoy High Court's Goldman Ruling

By **Nessim Mezrahi, Stephen Sigrist and Carolina Doherty**
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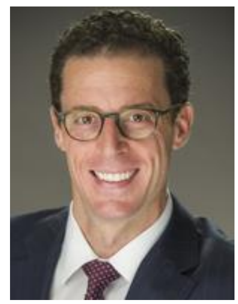

Nessim Mezrahi

Private enforcement of the federal securities laws is mission-critical to sustain the transparency of America's capital markets and uphold the rules of engagement between public corporations and shareholders that trust directors and officers to lead these institutions on their behalf.

According to our data and analyses — which are derived from proactive, independent, claim-specific, single-firm event study analyses — the second quarter of 2021 is tied with the second quarter of 2020, with roughly two of every five, or 39%, alleged stock drops claimed against U.S. issuers exhibiting an absence of back-end, or indirect, price impact.[1]

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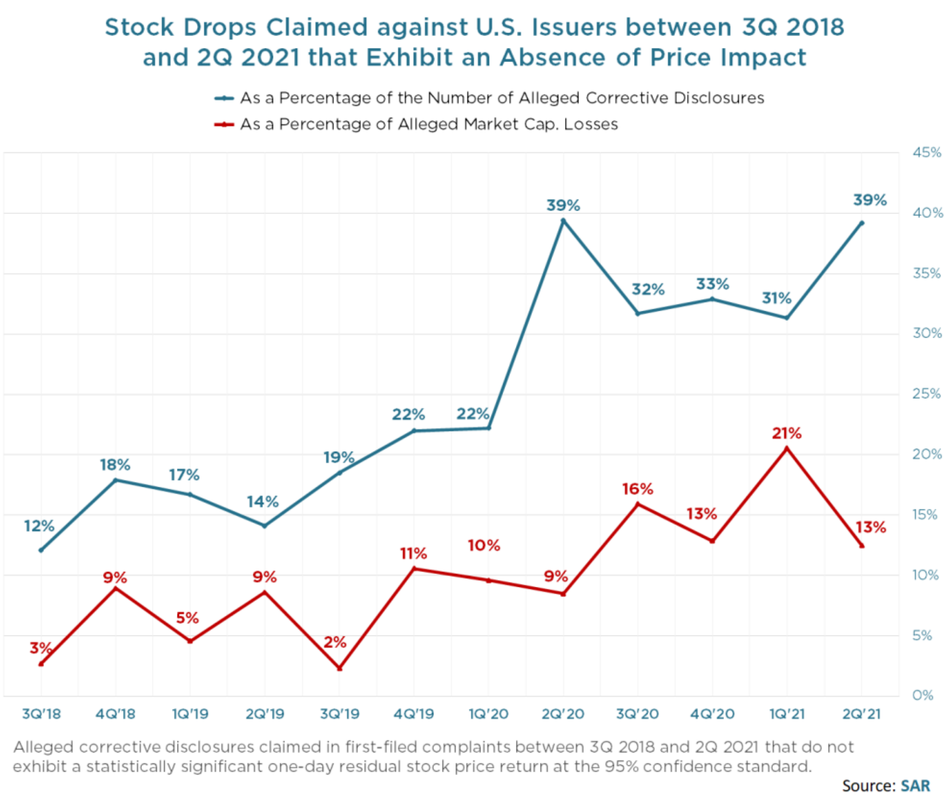

The U.S. Supreme Court's recent opinion in Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System supports the fact that an absence of statistical significance on stock drops that correspond to alleged corrective disclosures constitutes valid quantitative price impact evidence that a district court must accept to nullify plaintiffs' presumption of reliance in their attempt to attain a class certification award.

Upon the highly anticipated Goldman decision, securities class action litigators from both the defense and plaintiffs bar have posited in Law360 that the ruling has been a big win for their respective bars according to their legal interpretations of newly commanded class certification orders.

Undoubtedly, both sides will find traces of honey in the Goldman opinion, but the Supreme Court awarded the honeycomb to insurance carriers that have bankrolled the trial bar through seven years of unabated class certification leniency since Halliburton II in 2014, albeit with $30.1 billion in U.S. federally approved settlements.[2]

The Supreme Court in Goldman came through to support the objective of Halliburton II and equalized the class certification battleground to limit further securities class action indulgence by trigger-happy litigants that prosecute alleged violations of the federal securities laws under Sections 10(b) and 20(a) of the Securities Exchange Act and U.S. Securities and Exchange Commission Rule 10b-5 promulgated thereunder.

Justice Amy Coney Barrett delivered clear instructions to the securities class action bar: "In assessing price impact at class certification, courts 'should be open to all probative evidence on that question — qualitative as well quantitative — aided by a good dose of common sense.'"[3]

Based on our data and analyses, five Exchange Act Rule 10b-5 claims filed against U.S. issuers during the second quarter of 2021 exhibit a complete absence of back-end price impact; this means that not a single alleged stock drop exhibited a statistically significant one-day return at the 95% confidence standard after controlling for the effects of the general equity markets and industry-specific factors.[4]

Since the third quarter of 2018, investors have filed 49 securities class actions against U.S. issuers that allege violations of Rule 10b-5 that do not allege single stock drop that surpasses Halliburton II's statistical thresholds of price impact.[5]

Five of the 49 suits have not survived the motion to dismiss and three have settled, leaving 41 open Exchange Act Rule 10b-5 claims since June 2018 that do not warrant class certification according to the Goldman opinion.[6]

The Supreme Court decision in Goldman has effectively suppressed the trial bar's ability to monetize on burdensome and expensive shareholder battles caused by a lack of clarity on the district court's acceptability of price impact evidence during class certification proceedings.

By affirming the independent recommendation of the U.S. Department of Justice and the SEC to remand the Goldman case back to the U.S. Court of Appeals for the Second Circuit for further examination of price impact evidence, the Supreme Court has instituted a data-driven control that limits the proliferation of meritless securities class action litigation.[7][8]

Without data-driven evidentiary controls of front and back-end price impact, an unwarranted class certification award can create a litigation gravy train at the expense of insurers that protect America's public corporations and the directors and officers that lead them.

According to Bloomberg columnist Chris Bryant:

There will always be tension between shareholders' important right to seek legal redress and ensuring companies don't spend all their time in court. Soaring D&O premiums indicate that balance is increasingly out of kilter. Only the lawyers can be content.[9]

In today's uber litigious business environment, anomalous external events that affect a corporation's day-to-day operations are sparking seemingly meritless securities class actions that may not warrant class certification.

According to global insurer Zurich, "directors and officers who serve on a company's board of directors are chosen to lead the organizations and drive the strategies to help businesses thrive. Some of their decisions could also leave these individuals vulnerable to lawsuits made against them."[10]

Fortunately for them and their organizations, event-driven securities class actions can be dismissed with prejudice with well-crafted risk disclosures that enforce the safe harbor provisions afforded by the Private Securities Litigation Reform Act.

For example, in the data breach securities class action filed against Marriott International Inc. in 2019, U.S. Circuit Judge Paul W. Grimm of the U.S. District Court for the District of Maryland granted dismissal of the defendant's motion to dismiss with prejudice in a memorandum opinion that details the plaintiffs' Rule 10b-5 claim deficiencies.[11]

According to Kevin LaCroix of the D&O Diary, "[i]f nothing else, the opinions demonstrated that plaintiffs seeking to assert D&O claims based on cybersecurity incidents face an uphill battle."[12]

Unfortunately, directors and officers of public corporations may still be targeted by securities class action lawyers through the price inflation maintenance theory of securities fraud — which has been acknowledged by the Supreme Court, but not validated.

According to the Goldman opinion: "Although some Courts of Appeals have approved the inflation-maintenance theory, this Court has expressed no view on its validity or its contours. We need not and do not do so in this case."[13]

Investor plaintiffs that initiate a securities class action routinely rely on the theory of stock price inflation maintenance to allege that generalized corporate statements support a deliberate scheme of corporate shenaniganry that caused damages to shareholders when the stock price fell.

Plaintiffs support their securities claim by stating that because the allegedly related and misleading general corporate statements sustained an artificially inflated stock price, investors purchased common stock at a price that would not have been supported had the market known of the company's true ability to generate future cash flows prior to the falter.

The Goldman opinion affirmed that without proof that the stock price reacted when the corresponding and allegedly misleading and generalized statements were made, a class action is not procedurally appropriate to prosecute allegations of fraud on the market on behalf of allegedly similarly situated investors.

According to the Goldman opinion, "[t]he generic nature of a misrepresentation often will be important evidence of a lack of price impact, particularly in cases proceeding under the inflation-maintenance theory."[14]

Engulfed by rapidly evolving capital markets, an investor may press "buy" on a stock-trading mobile application with real-time alerts that are entirely unrelated to anything particularly specific to perfunctory and bland corporate statements made by the target company.

The federal judiciary will now face the legal conundrum of assessing whether a new breed of investor that purchases stock through a wholesaler that profits from transaction gamification by selling order flow, may be considered similarly situated as a more sophisticated institutional investor that depends on investment managers with fiduciary duties to clients when making investment decisions in the same stock.[15]

The Goldman opinion confirmed that if the allegedly misleading statement is not related to the allegedly rectifying information when stock price fell upon the revelation of truth, there can be no damages on a classwide basis because the presumption of reliance is inapplicable.

According to the Goldman opinion:

But that final inference — that the back-end price drop equals front-end inflation — starts to break down when there is a mismatch between the contents of the misrepresentation and the corrective disclosure. That may occur when the earlier misrepresentation is generic (e.g., "we have faith in our business model") and the later corrective disclosure is specific (e.g., "our fourth quarter earnings did not meet expectations"). Under those circumstances, it is less likely that the specific disclosure actually corrected the generic misrepresentation, which means that there is less reason to infer front-end price inflation — that is, price impact — from the back-end price drop.[16]

The Supreme Court's focus on the effect on stock price to validate whether an alleged false statement caused an allegedly related transactional loss that similarly situated investors may claim as damages when the truth is revealed, supports the thoughts professed by modern philosopher Immanuel Kant in his 1781 book, "The Critique of Pure Reason":

The majority of efficient causes in nature are simultaneous with their effects, and the temporal sequence of the latter is occasioned only by the fact that the cause cannot achieve its entire effect in one instant. But in the instant in which the effect first arises, it is always simultaneous with the causality of its cause, since if the cause had ceased to be an instant before, then the effect would have never arisen. Here one must note that it is the order of time and not its lapse that is taken account of; the relation remains even if no time has elapsed. The time between the causality of the cause and its immediate effect can be vanishing (they can therefore be simultaneous), but the relation of the one to the other still remains determinable.[17]

Price impact is a determinable effect that is evaluated through event study analysis to validate whether at the time when an alleged falsehood was made (front-end), or when it was discovered (back-end), stock price reacted sufficiently in response to the alleged fraud-related information.

Without proof of the effect (a statistically significant change in stock price), the cause (dissemination of an alleged misstatement or a corrective disclosure or the materialization of an undisclosed risk through an external disseminator) would be indiscernible, thereby severing the link of relatedness.

According to the Goldman opinion: "The defendant may then rebut the presumption through '[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.'"[18]

According to the book "Rule 10b-5 Private Securities-Fraud Litigation," written by Michael J. Kaufman and John M. Wunderlich in 2020, "the price impact presumption is a fundamental precondition to the reliance presumption; without the price impact presumption, the plaintiff cannot invoke the reliance presumption."[19]

Without the reliance presumption, investors' allegations of fraud of the market cannot be prosecuted as a class action on behalf of a group of allegedly similarly situated investors.

In a nutshell, the Supreme Court's Goldman opinion reinforced defendants' price impact shield and acknowledged plaintiffs' maintenance inflation sword, while cementing Halliburton II's class certification defenses to rebut the presumption of reliance from its 1988 Basic Inc.v. Levinson decision, in accordance with its 2013 Comcast Corp. v. Behrend decision, and without running afoul of materiality established in Amgen Inc. v. Connecticut Retirement Plans and Trust Funds in 2013.

The Supreme Court in Goldman has effectively disempowered trial lawyers from coasting through class certification proceedings and empowered America's public corporations with price impact evidence and the common sense of a federal judge to determine whether a private securities fraud claim is worthy of class action status.

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[1] SAR Securities Class Action (SCA) Rule 10b-5 Exposure Report — 2Q 2021. https://bit.ly/SAR_2Q_2021_Exposure_Report.

[2] ISS Securities Class Action Services. Figure of $30.1 billion as sourced by ISS SCAS includes all U.S. Federal securities class action settlements between July 1, 2014, and June 30, 2021, and excludes announced settlements with a future hearing or settlement date after July 1, 2021, SEC disgorgements, and antitrust settlements.

[3] Opinion of the Court, Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System, No. 20-222 (2021), internal citations to In re Allstate Corp. Securities Litigation (2020), and Langevoort, Judgement Day for Fraud-on-the-Market: Reflection on Amgen and the Second Coming of Halliburton, 57 Ariz. L. Rev. 37, 56 (2015); omitted.

[4] SAR Securities Class Action (SCA) Rule 10b-5 Exposure Report — 2Q 2021.

[5] SAR SCA Claims Database, as of July 1, 2021.

[6] Id.

[7] Brief for the United States As Amicus Curiae Supporting Neither Party, Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System, No. 20-222 (2021).

[8] Opinion of the Court, Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System, No. 20-222 (2021).

[9] "When Lawyers Charge $1,800 an Hour; Who Pays?" Chris Bryant, Bloomberg Business, June 21, 2021. https://www.bloomberg.com/opinion/articles/2021-06-21/when-lawyers-charge-1-800-an-hour-who-pays-d-o-insurance-fees-soar.

[10] "Directors and Officers (D&O) Liability Insurance; Management Liability D&O Fact Sheet," Zurich, 2020.

[11] Memorandum and Opinion, In re Marriott International, Inc., Customer Data Securities Breach Litigation; Securities Actions., MDL No. 19-md-2879.

[12] "Marriott Data Breach-Related Securities and Derivative Suites Both Dismissed," by Kevin LaCroix, The D&O Diary, June 15, 2021. https://www.dandodiary.com/2021/06/articles/securities-litigation/marriott-data-breach-related-securities-and-derivative-suits-both-dismissed/.

[13] Opinion of the Court, Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System, No. 20-222 (2021).

[14] Id.

[15] According to Chair Gary Gensler's testimony before the House Committee on Financial Services on May 6, 2021, the Securities and Exchange Commission is expected to publish a staff report this Summer regarding trading gamification and payment for order flow. https://www.sec.gov/news/testimony/gensler-testimony-20210505.

[16] Opinion of the Court, Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System, No. 20-222 (2021).

[17] Immanuel Kant, Critique of Pure Reason, (Cambridge, United Kingdom: Cambridge University Press 1998), Pg. 312.

[18] Opinion of the Court, Goldman Sachs Group Inc. v. Arkansas Teacher Retirement System, No. 20-222 (2021), internal citations to Basic Inc. v. Levinson, 485 U. S. 224 omitted.

[19] Michael J. Kaufman and John M. Wunderlich, Rule 10b-5 Private Securities-Fraud Litigation, (Thomson Reuters 2020), Pg. 463.