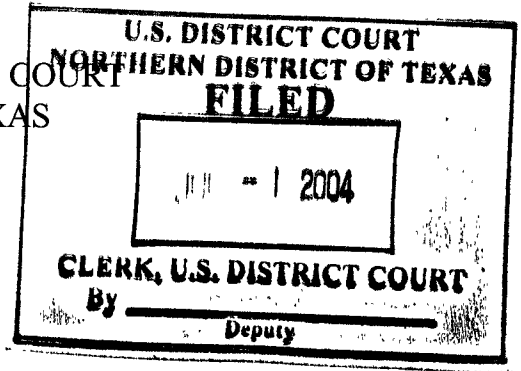


ORIGINAL

IN THE UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF TEXAS
DALLAS DIVISION



RICHARD BELL, *et al.*,

Plaintiffs,

v.

ASCENDANT SOLUTIONS, INC., *et al.*,

Defendants.

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Civil Action No. 3:01-CV-0166-N

MEMORANDUM OPINION AND ORDER

Before the Court are Defendants’ Motion to Exclude the Expert Testimony of Professor R. Richardson Pettit, filed March 24, 2004, and Plaintiffs’ Motion to Certify Class, filed September 12, 2003. Defendants argue that the principles and methodology employed by Plaintiffs’ expert witness fail to satisfy the standard for reliable expert testimony set forth by Federal Rule of Evidence 702 and *Daubert v. Merrill Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), and Professor Pettit’s testimony concerning market efficiency is accordingly inadmissible for the Court’s consideration of Plaintiffs’ Motion for Class Certification. Because Professor Pettit’s use of absolute values and the dates he chooses to support his contention of market efficiency are not reliable, Defendants’ motion to exclude is granted. Absent Professor Pettit’s testimony, the presumption of market efficiency, which would support an application of the fraud on the market theory, does not apply. Accordingly, proof of individual reliance is required for each Plaintiff, and Plaintiffs do not satisfy the

predominance element required for class certification under Federal Rule of Civil Procedure 23.

I. BACKGROUND

Plaintiffs purchased Ascendant Solutions Inc. (“Ascendant”) common stock between its initial public offering on November 11, 1999, and January 24, 2000. Ascendant provided proprietary software and comprehensive service solutions that enabled Internet retailers and direct marketing companies to outsource their order management and fulfillment operations. Plaintiffs allege that Ascendant and its top executives issued materially false and misleading statements regarding Ascendant’s sales, revenues, and business model immediately before and following Ascendant’s initial public offering, artificially inflating the price of Ascendant common stock. Specifically, Plaintiffs claim that Ascendant’s 1999 prospectus included false and misleading statements concerning the scope of Ascendant’s systems and services and its success in establishing successful systems for existing clients. According to Plaintiffs, the failures obscured by Ascendant’s public statements soon surfaced, resulting in a breakdown in Ascendant’s ability to generate order and shipping information, a loss of existing clients, and a swift drop in stock price.

On January 23, 2001, investors filed the first of five class actions against Ascendant and its top executives, alleging violations of federal securities laws. On April 25, 2001, the five actions were consolidated, and the Court appointed lead plaintiffs. The lead plaintiffs filed a consolidated amended class action complaint on July 26, 2002. The Court granted in part and denied in part Ascendant’s motion to dismiss by order dated July 22, 2003.

Plaintiffs filed the instant motion for class certification on September 13, 2003, without any supporting expert testimony. Ascendant contends that Plaintiffs do not satisfy the predominance requirement for a class action under Rule 23, because they fail to establish the element of efficiency needed in order to utilize the presumption of individual reliance through the “fraud on the market” theory. Plaintiffs in their reply for the first time offered expert testimony on market efficiency.¹ Defendants filed their Motion to Exclude the Expert Testimony of Professor R. Richardson Pettit on March 24, 2004, challenging the testimony of Professor Pettit concerning the market efficiency for Ascendant stock.

II. PROFESSOR PETTIT’S CONCLUSION THAT THE MARKET WAS EFFICIENT IS NOT RELIABLE

Initially, Plaintiffs argue that any consideration of the admissibility of Professor Pettit’s testimony is premature, since class certification is not the appropriate stage to indulge in a “battle of the experts.” While Plaintiffs are correct that the class certification stage is not the time to conduct an inquiry into the merits of the case, the Court must still determine whether Plaintiffs have met their burden of proving market efficiency – so as to satisfy the Rule 23 requirement of predominance – when considering class certification. *See Lehocky v. Tidel Technologies, Inc.*, 220 F.R.D. 491, 507-08 (S.D. Tex. 2004) (examining Professor Pettit’s analysis of market efficiency at class certification stage); *Krogman v. Sterritt*, 202 F.R.D. 467, 477 n.14 (N.D. Tex. 2001) (weighing conflicting expert testimony concerning market efficiency in order to conclude that plaintiff was not entitled to presumption of

¹The Court discourages that practice.

reliance for class certification purposes). Although many courts, such as the *Lehocky* court, weigh the admissibility of expert testimony in the context of a motion for class certification rather than a *Daubert*-style motion to strike, the Fifth Circuit has made clear that:

A district court certainly may look past the pleadings to determine whether the requirements of rule 23 have been met. Going beyond the pleadings is necessary, as a court must understand the claims, defenses, relevant facts, and applicable substantive law in order to make a meaningful determination of the certification issues.

Castano v. Am. Tobacco Co., 84 F.3d 734, 744 (5th Cir. 1996). In many cases, it makes sense to consider the admissibility of the testimony of an expert proffered to establish one of the rule 23 elements in the context of a motion to strike prior to considering class certification. See *McNamara v. Bre-X Minerals Ltd.*, No. 5:97-CV-159, 2002 WL 32076175, at *4 (E.D. Tex. Sept. 30, 2002) (considering defendants' rule 702 motion to strike expert's testimony of market efficiency prior to subsequent class certification analysis). In order to consider Plaintiffs' motion for class certification with the appropriate amount of scrutiny, the Court must first determine whether Plaintiffs' expert testimony supporting class certification is reliable. Accordingly, a *Daubert*-type review is not premature.

Defendants move to exclude Professor Pettit's testimony concerning the efficiency of the market for Ascendant stock, because, they contend, his analysis of stock price movement in response to company-specific news is severely flawed. Courts frequently utilize analysis of cause-and-effect relationship between unexpected corporate events or financial releases and immediate responses in the stock price in order to measure market efficiency. See *Cammer v. Bloom*, 711 F. Supp. 1264, 1287 (D. N.J. 1989); *Krogman*, 202

F.R.D. at 477. However, Professor Pettit's seemingly ad hoc use of "information days" and improper use of absolute value compels the Court to find his testimony unreliable.

Professor Pettit's identification of "information days" includes dates that appear to be consciously chosen in order artificially to support his hypothesis of efficiency. Many of the dates identified by Professor Pettit do not conform to any generally-accepted finance methodology used to establish efficiency.² For example, Professor Pettit includes November 11, 1999, the date of Ascendant's initial public offering, as an information day. Because the closing price on November 10, 1999 was not set on an open, efficient market – indeed, the stock was not available on November 10 – the "news" of an initial public offering cannot reasonably be said to be reflected in the stock's price change on November 11, 1999.

Similarly, the inclusion of December 1, 1999, appears to skew Professor Pettit's analysis artificially. Plaintiffs contend that a Bloomberg News article concerning the resignation of Ascendant's corporate operating officer was responsible for a statistically significant price change, showing the efficiency of the market for Ascendant stock by quickly reflecting the new information through stock price movement. However, the Bloomberg article, released late in the trading day, simply reports the earlier price drop and attributes such price movement to incorrect rumors circulating on Internet message boards. The use of Internet rumors as "information" to support a hypothesis that the market quickly reflects

²Professor Pettit's analysis is further complicated by his limited data set of just six or seven "information days," his failure to control for industry effects, and his inconsistent application of a two-day window.

unexpected corporate events or financial releases appears to be unprecedented in finance methodology.³ Certainly, it does not comport with the *Cammer* factors of market efficiency. *Cammer*, 711 F. Supp. at 1287.

Professor Pettit's inclusion of November 15, 1999, as an information day is similarly flawed. Plaintiffs suggest that November 15, 1999 is an appropriate "information day" because that day a Wall Street Journal article was published that included positive information concerning the Internet outsourcing industry. However, the news article did not mention Ascendant at all and does not appear to implicate Ascendant's business model directly. The *Cammer* efficiency factors evaluate whether stock price responds to company-specific news, not industry-specific news. *Cammer*, 711 F. Supp. at 1287; *Krogman*, 202 F.R.D. at 477.

In fact, while Ascendant's stock price rose an astonishing 69.7 percent from the market close on Friday November 12, 1999, through market close Monday, November 15, 1999 (defined in Professor Pettit's analysis as a 68.5 percent residual return), none of the stocks specifically mentioned in the Wall Street Journal article had a price increase higher than 4 percent. Indeed, over half of the stocks mentioned by name in the Wall Street Journal piece were unchanged or closed at a lower price, suggesting that the article could not have been responsible for the incredible one-day gain.

³Thus, while Internet rumors may one day be an acceptable basis for expert opinion in a court, use of them is not at present a reliable methodology.

Most importantly to the Court's analysis of Professor Pettit's methodology, the single data point provided by the November 15 price spike biases Plaintiffs' analysis so vastly that without that date, the difference between information and non-information days is not statistically significant. According to Professor Paul Gompers' report, the simple inclusion of November 15, 1999, without more, drives Professor Pettit's conclusion that Ascendant was traded on an efficient market. The very fact that the November 15 outlier alone dictates the result of Professor Pettit's analysis compels the Court to conclude that Plaintiffs have not established that Professor Pettit's testimony is the product of reliable principles and methods, as required by Federal Rule of Evidence 702.

In addition, Professor Pettit utilizes absolute value to determine market price reaction to company news, a technique never previously used to test for market efficiency and disavowed by the author of an article presented by Plaintiffs to support its use. Although the use of absolute value can certainly reflect responsiveness to new information, it cannot determine whether changes in stock price are unbiased, a central requirement of market efficiency theory. The very purpose of requiring market efficiency before applying the fraud-on-the-market presumption is severely undercut by ignoring the direction of price movement in response to new information. Indeed, if stock price is inversely related to the content of new information (for example, stock price decreases upon the announcement of good news, and increases on the announcement of bad news), a plaintiff class cannot be presumed to have relied upon positive statements in purchasing stock. This common sense conclusion explains why the use of true values, rather than absolute values, is generally accepted in the

field of financial economics, and absolute values have never been used to test for market efficiency. As Professor Gompers explains, the use of absolute values undercuts Professor Pettit's central conclusion, because:

Pettit treats absolute price changes as if they are distributed normally when converting t-values to significance levels. This is clearly incorrect, since a normal distribution includes negative values, while the absolute values of residuals cannot be negative. Accordingly, Pettit's claim that "there is a 97% and 98% probability that the market reactions are different (larger) on 'information days' than on 'non-information days'" is false because that conclusion is based on a normal distribution and absolute values are not distributed normally.

Rebuttal Expert Report of Paul A. Gompers, dated March 18, 2004, at 12. Accordingly, the techniques supporting Professor Pettit's finding of market efficiency have not been tested, have not been subject to peer review and publication, and do not enjoy general acceptance within a relevant scientific community. *Daubert*, 509 U.S. at 592-94. For those reasons, the Court finds Professor Pettit's testimony not to be reliable and grants Defendants' motion to strike it.

III. WITHOUT PROOF OF EFFICIENCY, PLAINTIFFS' MOTION FOR CLASS CERTIFICATION IS DENIED

Rule 23 of the Federal Rules of Civil Procedure sets forth the elements that must be met before a class is certified. First, Rule 23(a) states:

One or more members of a class may sue or be sued as representative parties on behalf of all only if (1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly and adequately protect the interests of the class.

FED. R. CIV. P. 23(a); *Stirman v. Exxon Corp.*, 280 F.3d 554, 558-59 (5th Cir. 2002). Also, the proposed class action must satisfy at least one element of Rule 23(b). *Id.* at 559. Here, Plaintiffs rely on Rule 23(b)(3), which requires that the questions common to the class predominate over questions affecting individual members and that a class action be superior to other available methods for the fair and efficient adjudication of the controversy. FED. R. CIV. P. 23(b)(3).

In the instant matter, Ascendant argues that Plaintiffs have failed to satisfy the element of predominance, because the individual plaintiffs cannot be presumed to have relied upon the representations of Ascendant without an initial showing that Ascendant common stock traded in an efficient market. Without establishing efficiency, Plaintiffs may not resort to the “fraud on the market” theory of reliance, and will have to establish individual reliance for each individual plaintiff – thus foreclosing class certification. *Castano v. Am. Tobacco Co.*, 84 F.3d 734, 745 (5th Cir. 1996) (“a fraud class action cannot be certified when individual reliance will be an issue”). District courts have consistently explained that:


The key issue regarding predominance is whether plaintiffs are entitled to a presumption of reliance applicable to all class members. *Griffin v. GK Intelligent Sys., Inc.*, 196 F.R.D. 298, 303 (S.D. Tex. 2000). The fraud-on-the-market presumption of reliance “is only available when a plaintiff demonstrates that a defendant made fraudulent misrepresentations or omissions concerning a security that is actively traded in an ‘efficient market,’ thereby establishing a ‘fraud on the market.’” *Binder v. Gillespie*, 184 F.3d 1059, 1064 (9th Cir. 1999) (citing *Basic Inc. v. Levinson*, 485 U.S. 224, 241-42(1988); *O’Neil v. Appel*, 165 F.R.D. 479, 498 (W.D. Mich. 1996); *Krogman*, 202 F.R.D. at 477; *GK Intelligent*, 196 F.R.D. at 303-04 (indicating that Plaintiff bears the burden of proof on showing that the market was efficient throughout the class period). Whether a company’s stock traded in an efficient market is a complex issue that requires an analysis of numerous

factors, including: (1) how quickly new information about the company is reflected in the stock price; (2) the stock's trading volume; (3) analyst coverage; (4) market maker activity; and (5) eligibility to file a Securities Exchange Commission ("SEC") Form S-3 registration statement. *Krogman*, 202 F.R.D. at 477. Federal courts typically look to expert testimony to decide this issue. *See, e.g., Krogman*, 202 F.R.D. at 477; *O'Neil*, 165 F.R.D. at 484.

Lehocky, 220 F.R.D. at 504-05.

Plaintiffs contend that efficiency has been established by the listing of Ascendant common stock on the NASDAQ National Market and the expert testimony of Professor Pettit. Initially, no court has ever held that efficiency is established solely by the listing of a stock on a national stock exchange. *See id.* at 505 n.15 ("The fact that a company's stock is listed on a national exchange does not establish that it trades in an efficient market."); *O'Neil*, 165 F.R.D. at 504 ("The issue is *not* whether NASDAQ is efficient. . . . No court has ever held that a finding of efficiency can be based on the mere fact that a stock is traded on NASDAQ . . .") (emphasis in original). In addition, the Court's holding that Professor Pettit's testimony does not satisfy Rule 702 or *Daubert* forecloses its use to establish market efficiency. Plaintiffs have thus failed to establish market efficiency, which prevents them from use of the "fraud on the market" presumption of reliance. Lacking the presumption of reliance, the question of individual reliance must be proved for each Plaintiff, and the Rule 23 requirement of predominance is not established. Accordingly, Plaintiffs' motion for class certification is denied.

SIGNED this 1 day of July, 2004.



David C. Godbey
United States District Judge