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Limiting The Severity Of Deficient Securities Fraud Claims

By **Nessim Mezrahi and Stephen Sigrist** (January 8, 2021, 4:45 PM EST)

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In 2018, Columbia Law School professor John C. Coffee Jr. indicated that the "scope of 'event-driven' litigation could expand rapidly," which it has, and led to successful recoveries for public equity investors in BP PLC in 2017, Petrobras in 2018, Signet Jewelers Ltd. in 2019 and Equifax Inc. in 2020, among others.[1]

As 2021 kicks off and investors frolic on the peaks of public equity valuations, the sustained frequency of securities class actions since 2017 continues to layer on new long-tail claims on insurers' bloated inventories. The growth and evolution of Rule 10(b)-5 private securities fraud litigation has been manna from heaven for the trial bar. This has not been the case for insurers in the professional liability insurance industry.

Stephen Sigrist

In 2018, the reinsurer TransRe alerted cedents that "[i]t should come as no surprise to followers of the U.S. Public D&O liability market that our recent proprietary analysis reveals price inadequacy — the level of compensation in the market is not commensurate with the risks being taken."[2]

In 2019, Insurance Insider reported that TransRe's "[m]ispricing on these liability lines has generated a $3bn to $5bn hole in reserves, stemming significantly from [directors and officers liability]."[3]

John Keogh, the newly appointed president of Chubb Group, concluded:

> In the current legal environment, however, the class benefitting most from such litigation is not shareholders. Rather, the real winner is a growing cohort of lawyers who are filing meritless lawsuits in federal and state courts across the United States every time a merger or acquisition is announced or a corporate misfortune impacts a company's share price. ... In the last five years, half of the nearly $23 billion in securities claims costs have gone to lawyers — both plaintiff and defense.[4]

Since 2017, the plaintiffs bar has expanded its corporate fraud deterrence regime by enforcing changes in managerial behavior through pricey corporate therapeutics, like the $310 million corporate governance and compliance reforms attained in In re: Alphabet Shareholder Derivate Litigation.[5]

According to Swiss Re's chief economist for the Americas, "[t]he plaintiff bar's applied psychology tactics (focus on emotions rather than facts) will spread as more law firms adopt them."[6]

The trial bar's reliance on the tort liability system to attempt to solve societal issues may not deter corporate fraud sufficiently to curb the frequency of securities class action litigation in the immediate term — but, it does burden corporations with even more costly litigation.

The confluence of sustained securities class actions and increasing shareholder derivative lawsuits have, in fact, compounded the costs that U.S.-listed corporations and insurers expense to defend complex litigation against different cohorts of plaintiffs.

In today's restricted business environment, the trial bar is winning a costly multifront war on directors and officers that are focused on managing public corporations to get America back to work in the wake of the COVID-19 pandemic.

In their defense, insurance companies have been forced to adjust the economics of claims-made executive liability policies according to the changing dynamics of two basic drivers of carrier profitability: premiums and expenses.

According to an AM Best's special report on the U.S. professional liability industry, the former has been materially impacted by a plethora of new risks and exposures facing directors and officers of publicly listed companies, and the latter by external legal costs tied with ensuing securities class action litigation on the risks that allegedly materialized without appropriate corporate disclosure to investors.[7]

> Over the last few years, the profitability of underwriting D&O liability coverage has been tested by adverse trends, most notably the growing number of lawsuits filed and the size of jury awards and settlements. Event-driven litigation spurred by claims of sexual harassment, other types of discrimination, or cyber attacks has also complicated the landscape for professional liability insurers. … These negative factors have led to a steady increase in both loss costs for settlements along with defense and cost containment expenses.[8]

According to Brian Finlay, who heads D&O treaty liability for TransRe North America, the professional liability industry is now in a "transitionary market."[9] The impact of sustained securities class actions and increasing shareholder derivative litigation has propelled a reset in the underwriting cycle of the professional liability insurance industry, which "is notorious for its pattern of rising and falling prices and profits, particularly in long-tail lines."[10]

The combination of an empowered trial bar and an ever-expanding scope of securities class action litigation has prompted scrutiny by the federal judiciary. Federal courts have taken swift action to address the growth of class action litigation by stress testing complex litigation processes, such as amendments to civil procedures of class action settlements.

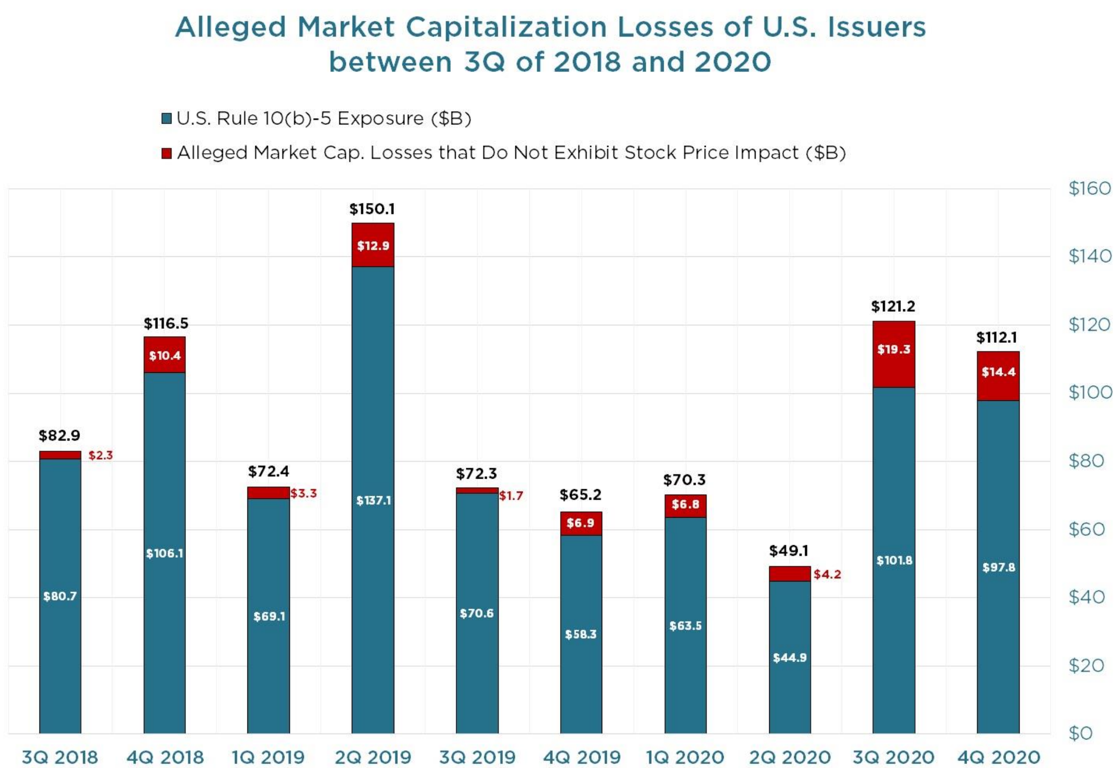
According to the American Bar Association, amendments to Rule 23 "should in some ways lead to a more streamlined, predictable class action settlement process. Predictability should make navigating settlement easier."[11]

Heightened inspection of class action procedures by federal judges, with the assistance of special masters, has raised the standards of professional practice for all practitioners in the securities class action sphere. Focused judicial scrutiny has enhanced transparency into opaque legal maneuvers that support the adjudication of indemnifiable securities claims.

Increased judicial scrutiny is not surprising given the fact that around 10% of $712.7 billion in aggregate market capitalization losses from alleged violations of the Exchange Act and Rule 10(b)-5 during 2019 through 2020 do not have judicial merit according to recent guidance on price impact defenses following the U.S. Supreme Court's Halliburton Co. v. Erica P. John Fund Inc., or Halliburton II.[12]

To put this figure into perspective, according to Bloomberg CityLab data, "Americans may collectively owe $70 billion by January, when the current federal eviction moratorium is set to expire."[13]

Undoubtedly, this figure is not trivial. The data indicates that nearly 50%, or $33.7 billion, of nonmeritorious alleged market capitalization losses in the last two years, were claimed against U.S. issuers in the third and fourth quarters of 2020 during the COVID-19 pandemic.[14]



Alleged market capitalization losses claimed on first-filed Rule 10(b)-5 Exchange Act claims between 3Q 2018 and 4Q 2020. Stock price impact is evaluated by testing the one-day residual decline of stock price at the 95% confidence standard on the alleged corrective disclosures.

Source: SAR

After discounting the nonmeritorious portion of alleged market capitalization losses of defendant U.S. issuers, we estimate that corporate exposure to Rule 10(b)-5 private securities fraud litigation amounts to $335 billion in 2019 and $308 billion in 2020, with litigation rates equating to 4.54% and 4.36%, respectively.[15]

We estimate that approximately 7%, or $22.8 billion, of Rule 10(b)-5 exposure of U.S. issuers in 2020, is related to COVID-19.[16] Slightly more than half of the COVID-19 related alleged losses have been claimed on matters filed between the first and second quarters of 2020, and approximately 33%, or $7.6 billion, were claimed during the fourth quarter, driven primarily by the securities class action against Royal Caribbean Cruises Ltd.[17]

Corporate exposure of non-U.S. issuers that trade on U.S. exchanges through American depository receipts to Rule 10(b)-5 Exchange Act claims amounts to $130.5 billion in 2020, with a litigation rate of 1.35%.[18] Over 60% of exposure stems from securities class actions filed during the fourth quarter of 2020, leading to the highest Rule 10(b)-5 exposure rate for non-U.S. issuers since we have been tracking this data.[19]

It is likely that securities class action frequency may increase if market corrections materialize after a record-setting 2020 on Wall Street.[20]

According to Institutional Shareholder Services Inc., "2019 yielded $3.21 billion in settlement funds for distribution, a marked decrease from the $6.1 billion recovered in 2018."[21] In 2020, ISS reports that securities class action settlements available for distribution exhibited an increase of 61% to $5.84 billion.[22]

In today's increasingly competitive landscape among global stock exchanges, the annulment of nonmeritorious class actions that allege violations of the federal securities laws under Section 10(b) and 20(a) of the Securities Exchange Act and Rule 10(b)-5 thereunder, can be attained through stricter dependence on empirical evidence earlier in the securities class action life cycle.[23]

According to recent guidance on Halliburton II price impact defenses from the U.S. Court of Appeals for the Second Circuit and the U.S. Court of Appeals for the Seventh Circuit — in In re: Chicago Bridge & Iron Co. NV Securities Litigation and in In re: Allstate Corp. Securities Litigation, respectively — approximately $82 billion in market capitalization losses that have been claimed to be rectifying allegedly materially misleading statements and omissions by directors and officers of U.S. issuers during the preceding 10 consecutive quarters, cannot translate into aggregate damages for the benefit a purported class of defrauded shareholders.[24]

The class certification opinion and order in the Second Circuit dictates:

[A] defendant can rebut the Basic presumption with evidence that the alleged misrepresentation was not associated with "negative price stock-returns," i.e., there was no statistically negative, "back-end" impact on stock following a corrective disclosure.[25]

The more recent class certification memorandum opinion and order in the Seventh Circuit dictates:

At this stage, it is defendants' burden to demonstrate a lack of price impact. This is difficult to do in the face of allegations that the stock price dropped following a corrective disclosure. To prove lack of price impact, defendants "must show by a preponderance of the evidence that the entire price decline on the corrective-disclosure dates was due to something other than the corrective disclosures."[26]

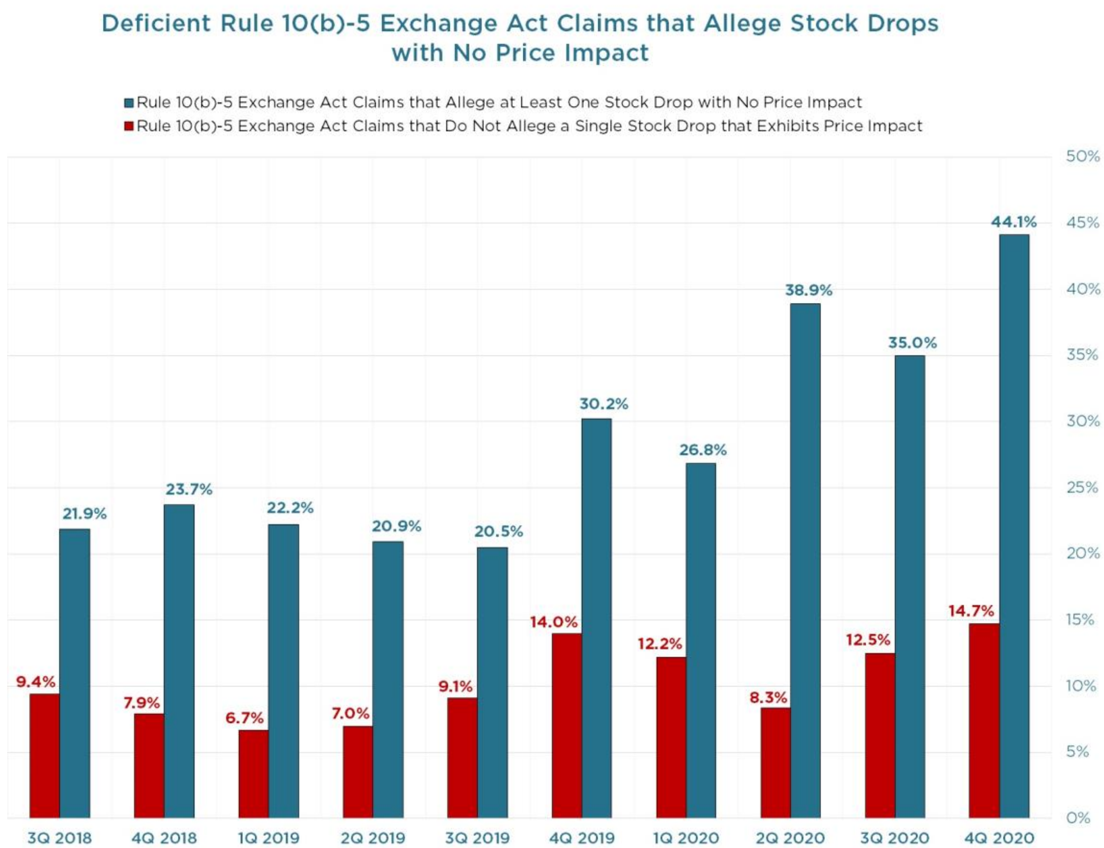
Both Chicago Bridge and Allstate share similar logic on Halliburton II and stipulate that any evidence that demonstrates that stock price did not decline due to company-specific factors when the truth of an alleged fraud was revealed through a corrective disclosure, is sufficient to negate class certification by rebutting the presumption of reliance.[27]

The court in Allstate went a step further and demanded that the defendants exercise basic reliance on independent event study analysis to evaluate stock price impact on alleged stock drops at the class certification stage. According to the class certification order, "[g]iven the lack of an independent event study or disaggregation analysis, defendants have failed to provide any support for their argument. Consequently, Defendants have failed to persuade the court of a lack of price impact."[28]

The Allstate ruling also confirms that the examination of stock price reaction on the alleged misstatements may not rebut the presumption of reliance when investors' counsel allege that directors and officers purposely maintained stock price at artificially inflated prices for their own interests over those of the shareholders.[29] According to U.S. District Judge Robert Gettleman's order:

[P]laintiffs rely on the inflation maintenance theory to allege that each statement maintained an already inflated stock price, and that the price would have dropped had Allstate revealed the truth. … Arguments that the stock price did not increase after the statements are therefore irrelevant. [The expert] erroneously conflates the lack of an increase with the lack of inflation. [The expert's] first argument consequently fails to rebut the Basic presumption in light of plaintiffs' inflation maintenance theory.[30]

Data and analyses indicate that econometrically unfit Rule 10(b)-5 Exchange Act claims — those with price impact deficiencies — are consuming notable real estate on dockets across the federal judiciary.



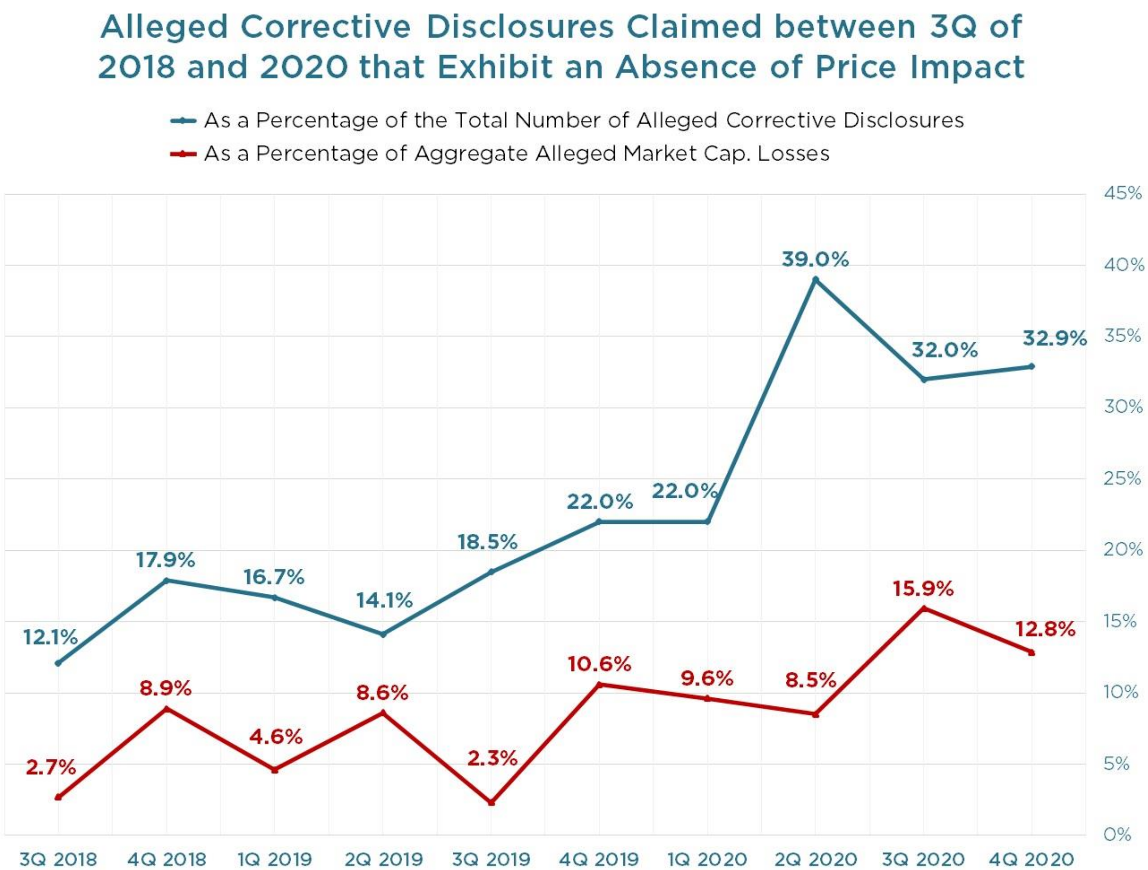
Deficient first-filed Rule 10(b)-5 Exchange Act claims filed between 3Q 2018 and 4Q 2020 that exhibit a verifiable absence of stock price impact on the alleged corrective disclosures.

Source: SAR

The results of our independent event study analyses on 397 Rule 10(b)-5 Exchange Act claims indicate that since the third quarter of 2018, 10% of first-filed securities class action complaints do not allege a single stock drop that exhibits price impact when the truth related to the alleged fraud was publicly disclosed to participants in the market.[31]

Our data and analysis also demonstrates that 28% of the first-filed Rule 10(b)-5 Exchange Act claims allege at least one stock drop that does not exhibit price impact at the 95% confidence standard.[32]

Our independent empirical evidence of stock price reaction, after controlling for general and industry-specific factors, on 736 alleged stock drops claimed in the corresponding sample of Rule 10(b)-5 Exchange Act claims, indicates that 23% of the alleged corrective disclosures claimed since the third quarter of 2018 exhibit an absence of back-end price impact.[33]



Alleged corrective disclosures claimed in first-filed Rule 10(b)-5 Exchange Act claims filed between 3Q 2018 and 3Q 2020 that do not exhibit a statistically significant one-day residual stock price return at the 95% confidence standard.

Source: SAR

Data and analysis indicates that in 2020 alone, about 32% of alleged corrective disclosures exhibit a verifiable absence of stock price impact. The U.S. Supreme Court in Halliburton II was clear:

Without the presumption that a public, material misrepresentation will distort the price of stock traded in an efficient market, and that anyone who purchases the stock at the market price may be considered to have done so in reliance on the misrepresentation, a Rule 10b-5 suit cannot proceed as a class action, as each plaintiff would have to prove reliance individually, so common issues would not predominate over individual ones, as required by the class action rule; price impact is thus an essential precondition for any Rule 10b-5 class action.[34]

Our empirical evidence, which is derived from the uniform application of single-firm event study analysis on 397 Rule 10(b)-5 Exchange Act claims filed during the last 10 consecutive quarters, indicates that Halliburton II defenses are highly effective in limiting — and potentially eliminating — alleged aggregate damages on open securities class actions that exhibit verifiable deficiencies of stock price impact.[35]

Without the support of a unified Congress that can effectuate another round of private securities litigation reform, it is unlikely that the domineering trial bar will summon the discipline to expunge unwarranted securities class action litigation. Plaintiff combatants that operate on contingency are incentivized to increase the rate of return on law firm partners' capital by filing more cases.

Filing frequency, compounded by a presumed magnitude of potential aggregate damages, has presented an economic boon for class action defense lawyers that do not place any capital at risk to defend these claims. In the current legal environment, the incentives for securities class action litigants on both sides of the "v" are misaligned with those of directors and officers of U.S.-listed corporations and their insurers.

Focused congressional reform can rectify well-documented issues that facilitate the filing of nonmeritorious securities class actions that are affecting U.S.-listed corporations in the wake of the COVID-19 pandemic.[36]

Until a unified Congress decides to address these complex issues through legal reform, data and analysis indicates that continued enforcement by federal judges on Haliburton II's evidentiary requirements of price impact at the class certification stage provides an effective solution to disqualify deficient Rule 10(b)-5 Exchange Act claims.

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