Assessing Securities Class Action Risk With Event Analysis

By Nessim Mezrahi (January 22, 2020)

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According to a recent article in the Harvard Law School Forum on Corporate Governance, the board of directors of a U.S. publicly traded corporation "has a fiduciary duty to promote the best interests of the corporation, and in fulfilling that duty, directors must exercise their business judgment in considering and reconciling the interests of various stake holders and their impact on the business of the corporation."[1]

Another says that this new era of corporate governance prompts "greater director engagement in risk oversight and monitoring activity, renewed emphasis on management-to-board reporting and increased director sensitivity to recognizing possible 'red flags.'"[2]

Adverse events that have materialized during the preceding two years constitute possible red flags that may in fact trigger a securities class action that alleges violations of Section 10(b) of the Securities Exchange Act of 1934 and U.S. Securities and Exchange Commission Rule 10b-5 promulgated thereunder.

In 2019, U.S. corporate exposure to securities class actions that allege violations of the federal securities laws under Section 10(b) and 20(a) of the Exchange Act amounted to $321.1 billion.[3] This aggregate exposure amount stems solely from alleged corrective disclosures that surpass thresholds of indirect price impact.[4]

The predictability of what corporation will be the target of a securities class action is uncertain, but the range of potential exposure and severity is not. The U.S. federal court system has established and documented well-detailed instructions on how aggregate, or classwide, damages are determined.

The U.S. Supreme Court has "repeatedly endorsed the use of class actions in adjudicating claims under the federal securities laws."[5] As a result, boards of directors must rely on the professionals that represent and protect them to be well informed of the risk and exposure of a potential securities class action.

Counsel has an elevated duty to recommend, draft and implement robust compliance directives that lay the foundations on how to hold C-suite executives accountable for the management of information that is disseminated to participants in the market, particularly after the Supreme Court ruling in Lorenzo v. SEC., “in which the Court held that those who disseminate false or misleading statements with the intent to defraud — even if they are not the 'maker' of the statement — can be found to have violated subsections (a) and (c) of Rule 10b-5.”[6][7]

Directors have a fiduciary duty to ensure that the corporation is sufficiently covered and well prepared to manage the risk and related exposure borne from adverse events that a reasonably diligent plaintiff may utilize to substantiate an Exchange Act claim that alleges violations of Rule 10b-5.[8]

Newly emphasized scrutiny of fiduciary duties by directors of publicly traded corporations gives rise for the need of a company-specific risk assessment of potential violations of the federal securities laws. This type of risk assessment is effectuated by identifying and

quantifying exposure from high-risk adverse events that have materialized during the preceding two years.

Adverse events that have materialized may be considered material enough, and potentially corrective, to trigger and substantiate a securities class action for alleged violations of the Exchange Act or Securities Act.

Empirical analysis that applies the industry-accepted event study methodology is the most effective tool to identify a high-risk sample of adverse events and quantify the exposure that has dissipated from the company's market capitalization during the preceding two years.

Event studies are:

> regression models that are most often used in 10b-5 cases at the class certification stage for two distinct but closely related purposes: (i) testing whether the market in which the relevant security traded was efficient; and, (ii) testing whether an alleged affirmative misrepresentation or corrective disclosure affected the price of the relevant security.[9]

At least three unique, yet related, conditions must be present to seed a high-risk adverse event that exposes directors and officers to risk of a securities class action for alleged violations of Rule 10b-5.

First, the corporation must have issued a press release disseminating certain new and material information that the board of directors affirm is necessary for investors that buy and sell shares of common stock in the open market.

Second, the corporation must have filed registration statements, periodic reports and other forms with the SEC to fulfill the duties of participating in the U.S. capital markets.

Third, the corporation's stock price must have exhibited verifiable evidence of indirect price impact — basically, the one-day residual return of stock price is statistically significant at the 95% confidence standard on the corresponding trading session. Case law establishes that "5% is the standard — though not exclusive — decision rule employed by courts in this context."[10]

The materialization of high-risk adverse events may not only prompt an event-driven securities class action but may also lead to a regulatory investigation by a government agency, as in the recent case of Under Armour Inc. in the U.S. District Court for the District of Maryland.[11][12]

From a risk management perspective, identifying and cataloging high-risk adverse events for U.S.-listed corporations is a valuable empirical analysis that provides directors and officers their present-day risk and exposure to an event-driven securities class action.

Every U.S.-listed corporation can have a record and catalog of the universe of high-risk adverse events. Directors and corporate stakeholders can rely on empirical evidence to more accurately assess securities class action risk and implement corporate governance systems that promote the best interests of the corporation.[13]

This is similar to tracking a driver's number of moving violations that have amassed over a period of time to assess the risk and determine the premium and deductible for securing

sufficient automobile insurance.

Cataloging high-risk adverse events that have materialized during the preceding two years also provides empirical evidence that counsel can rely on to evaluate the newness of alleged corrective disclosures claimed in an Exchange Act or Securities Act securities class action.

This ongoing empirical exercise provides corporations a tactical defensive tool to effectively challenge and disqualify alleged corrective disclosures that plaintiffs' counsel claim contains new potentially material information that allegedly rectifies a related materially misleading misrepresentation or omission.

In re: Chicago Bridge & Iron Company NV Securities Litigation in the U.S. District Court for the Southern District of New York, defendants have introduced two new ways to rebut Basic Inc. v. Levinson's presumption of reliance:

1. The information disclosed is not new; and
2. The information is not corrective.[14]

Results of the newness test can be instrumental to rebut the presumption of reliance and effectively negate any attribution of aggregate damages to the corresponding corrective disclosures that do not contain new information that has not already affected shareholders.

> Given this holding and at least one other subsequent district court proceeding, a "newness" analysis of the proffered corrective disclosure is required in this Circuit. … If a court finds that the alleged corrective disclosure is: (i) not new, (ii) not related to the subject or the misrepresentation, (iii) merely speculative or negative commentary, and if the misrepresentation did not cause a price increase when made, then the defendants will have "severed the link" between the misrepresentation and the stock price. In short, I conclude that a limited analysis of an alleged disclosure as to whether it is "corrective" is appropriate at this stage of the proceedings.[15]

Aggregate damages in securities class actions can only be established if any of the alleged corrective disclosures disseminated to market participants contain new and corrective information that is related to a corresponding alleged material misrepresentation or omission.

> With respect to corrective disclosures, where the disclosure provided no new information or was otherwise not "corrective," Defendants have successfully severed the link between the related misrepresentations without front-end impact and the stock price.[16]

Today, the benefits of Halliburton Co. v. Erica P. John Fund Inc.'s, or Halliburton II's, price impact defenses can be quantified. Data and analyses indicate that in 2019, 225 of 276 alleged corrective disclosures — adverse events that are claimed to be corrective disclosures in an Exchange Act claim for alleged violations of Rule 10b-5 — do not surpass thresholds of indirect price impact using the well-established 95% confidence standard.[17]

> There are two ways that a defendant can show lack of price impact. First, a defendant can provide direct "evidence of no 'front-end' price impact" — meaning that when an alleged misrepresentation was made, it "had no discernible impact on [the] stock price." Second, a defendant can rebut the presumption with evidence of

no back-end price impact — meaning that there was no decrease in price following a claimed corrective disclosure.[18]

Data is available to effectively test the newness of alleged corrective disclosures that surpass established statistical thresholds of indirect price impact. If the information that comprises an alleged corrective disclosure has already been previously disclosed via a high-risk adverse event that affected participants in the market with evidence of indirect price impact, then any alleged attribution of potential aggregate damages to a new alleged corrective disclosure may be not warranted because its inclusion in a certified class is not justified according the newness test.

Applying empirical evidence through the application of event study methodology provides data-driven analysis that directors and officers can rely on to effectively assess the risk and exposure of a potential securities class action.

A company-specific catalog of high-risk adverse events provides robust evidence that can be used to evaluate whether alleged corrective disclosures are in fact disseminating new information that has not previously affected shareholders.

Executives who are considering a position on the board of directors of a publicly traded company benefit from knowing whether the self-insured retention and insurance limits are sufficient to cover their potential liability based on the corporation's embedded securities class action risk stemming from high-risk adverse events that have materialized during the preceding two years.

Boards of directors deserve to know whether the corporation is sufficiently covered and equipped with a robust corporate governance risk management program to deter — and, if necessary, combat and defend — a securities class action.

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[1] "Some Thoughts for Boards of Directors in 2020," Martin Lipton, Steven A. Rosenblum, Karessa L. Cain and Kathleen I. Tatum of Wachtell, Lipton Rosen & Katz, Dec. 10, 2019. https://corpgov.law.harvard.edu/2019/12/10/thoughts-for-boards-of-directors-in-2020/.

[2] “Bernie Ebbers’ and Board Oversight of the Office of Legal Affairs,” Michael W. Peregrine of McDermott Will & Emery LLP. https://corpgov.law.harvard.edu/2020/01/11/bernie-ebbers-and-board-oversight-of-the-office-of-legal-affairs/.

[3] “U.S. Corporate Exposure to Alleged Violations of the Securities Exchange Act Amounts to $50.9 billion in 4Q 2019 and $321.1 billion in 2019,” Jan. 10, 2020, SAR. https://www.prnewswire.com/news-releases/us-corporate-exposure-to-alleged-violations-of-the-securities-exchange-act-amounts-to-50-9-billion-in-4q-2019-and-321-1-billion-in-2019--300984800.html.

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

[5] Appaloosa Investment LP et al v. Chicago Bridge & Iron Company NV et al. See, Special Master Report and Recommendation Regarding Class Certification and Appointment of Class Representatives and Class Counsel, by Honorable Shira A. Scheindlin dated Oct. 16, 2019.

[6] Lorenzo v. SEC, 139 S. Ct. 1094 (2019).

[7] “Potential Rule 10b-5 Liability for Misleading Statements and Omissions,” Israel David, of Fried, Frank, Harris, Shriver and Jacobson LLP, Dec. 18, 2019. https://corpgov.law.harvard.edu/2019/12/18/potential-rule-10b-5-liability-for-misleading-statements-and-omissions/.

[8] “Second Circuit Clarifies Standard Regarding Knowledge Of Facts That Constitute A Securities Fraud Violation For Purposes Of Triggering The Two-Year Statute of Limitations For Rule 10b-5 Claims,” Corporate & Securities Law Blog, Sheppard Mullin. https://www.corporatesecuritieslawblog.com/2011/03/second-circuit-clarifies-standard-regarding-knowledge-of-facts-that-constitute-a-securities-fraud-violation-for-purposes-of-triggering-the-two-year-statute-of-limitations-for-rule-10b-5-claims/.

[9] Appaloosa Investment LP et al v. Chicago Bridge & Iron Company NV et al. See, Special Master Report and Recommendation Regarding Class Certification and Appointment of Class Representatives and Class Counsel, by Honorable Shira A. Scheindlin dated Oct. 16, 2019.

[10] Id.

[11] “Under Armour Is Subject of Federal Accounting Probes,” Wall Street Journal, Nov. 4, 2019. https://www.wsj.com/articles/under-armour-is-subject-of-federal-accounting-probe-11572819835.

[12] In re: Under Armour Securities Litigation.

[13] See, “Enterprise Risk Management — Applying Enterprise Risk Management to Environmental, Social and Governance Related Risks.” Committee of Sponsoring Organizations of the Treadway Commission (COSO) — COSO ERM Framework component on governance and culture and the five associated principles: (1) Exercises board risk oversight, (2) Establishes operating structures, (3) Defines desired culture, (4) Demonstrates commitment to core values, and (5) Attracts, develops and retains capable individual. https://www.coso.org/Documents/COSO-WBCSD-ESGERM-Guidance-Full.pdf.

[14] Appaloosa Investment LP et al v. Chicago Bridge & Iron Company NV et al. See, Special Master Report and Recommendation Regarding Class Certification and Appointment

of Class Representatives and Class Counsel, by Honorable Shira A. Scheindlin dated Oct. 16, 2019.

[15] Ibid.

[16] Ibid.

[17] Ibid.

[18] Ibid.