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Securities Class Period Selection Deserves Greater Scrutiny

By **Nessim Mezrahi** (October 24, 2019, 4:17 PM EDT)

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The class period interval in securities class actions that allege violations of the federal securities laws under Section 10(b) and 20(a) of the Securities Exchange Act of 1934 is the second most fundamental determinant of the magnitude of potential aggregate — or classwide — damages.

Undoubtedly, the first is the number of shares of common stock sold by participants in the market in response to an alleged corrective disclosure that is alleged to be related to a specific misstatement or omission disseminated by directors and officers.

The length of the class period not only affects the magnitude of potential aggregate damages, but is also a key factor affecting the selection of the proposed lead plaintiff that may represent a purported class of defrauded shareholders.

The federal court system has established specific lead plaintiff selection criteria that incentivize plaintiffs attorneys to claim alleged artificial inflationary periods that are aligned with the maximization of their clients' losses in order to participate in potential rewards of successful securities class action litigation, which have become significant.[1]

U.S. District Judge Robert M. Dow Jr. wrote in an Oct. 9 memo in Timber Hill LLC v. The Kraft Heinz Co. et al. in the U.S. District Court for the Northern District of Illinois:

> Most courts consider: “(1) the total number of shares purchased during the class period; (2) the net shares purchases during the class period (in other words, the difference between the number of shares purchased and the number of shares sold during the class period); (3) the net funds expended during the class period (in other words, the difference between the amount spent to purchase shares and the amount received for the sale of shares during the class period); and (4) the approximate losses suffered.” ... While courts differ on the precise weight to apply to each factor, most courts agree that the fourth factor—the approximate losses suffered—is the most salient factor in selecting the lead plaintiff.[2]

Based on the court’s implied emphasis on the fourth factor, some competing plaintiff firms may prioritize the selection of a class period interval that is based on the timing of when purchases and sales of their clients' shares occurred in relation to the final corrective disclosure. “For the purpose of

calculating losses in determining the proper lead plaintiff in securities class actions, the courts use the most inclusive Class Period," Dow said.[3]

Because of the court's emphasis on selecting a lead plaintiff with the greatest losses, class period interval determination by plaintiffs counsel may be unrelated to the timing of when the alleged fraud actually began. The start date of the class period is a key driver that is regularly used by plaintiffs to top the podium at the lead plaintiff contest.

Lead plaintiff competitions are not a race to the courthouse or a test of the fittest. They have become a race where the winner represents the biggest loser. Because of the court's emphasis on proposed lead plaintiffs losses, the competition does not necessarily test which firm has applied the most rigorous and robust investigation of alleged malfeasance by directors and officers. The barriers to filing a securities class action for alleged Exchange Act violations have been lowered, and this presents greater risks for directors and officers of publicly traded companies.

Less established securities plaintiff firms have strong incentives to select a class period start date that fits with the potential clients that would yield them the greatest amount of alleged losses regardless of the strength of their internal investigation, if any. Established firms on the other hand, expend greater resources and engage in robust investigatory efforts with qualified in-house professionals that can attain indicative evidence of when a potential alleged violation of the federal securities laws began to take place.

An over-inclusive class period that backtracks through years of quarterly reporting periods will not only make scienter and loss causation allegations much harder to prove if a class is certified, but it may also artificially inflate potential classwide damages by attempting to allege that the fraud began much sooner than realistically possible.

Backtracking a class period start date over years of quarterly reporting periods without rigorous and verifiable investigatory work is akin to what fraud investigator Harry Markopolos attempted by alleging that a decade-long fraud was manifested by dozens of directors and officers across the globe at General Electric Co.[4]

The class period time frame is a powerful lever controlled by plaintiffs attorneys from the start of the action. This lever has a measurable and material effect on exposure, liability, potential damages, settlement ranges, shareholder recovery, defense fees and plaintiffs counsel award.

For example, in the securities class action In re General Electric Securities Litigation, the first complaint alleged that directors and officers began to misrepresent certain information related to the H-class gas turbine on Oct. 12, 2018.[5] The claim originally alleged a 2 1/2-week class period with a single corrective disclosure, leading to a claimed exposure of $8.5 billion.

The first amended complaint subsequently claimed that the alleged fraud began almost three years ago, on Dec. 4, 2017. The amended claim alleged at least eight corrective disclosures that yield a claimed exposure of $33.2 billion.[6] In other words, during the pleading stages of the litigation — prior to the motion to dismiss — alleged exposure in this claim has increased by 290%.

A similar scenario is now playing out the Phillip Morris International Inc. Securities Litigation.[7] The first complaint alleged that directors and officers misrepresented information to investors during a two-month period starting on Feb. 8, 2018, with an initial exposure estimated at $24.6 billion stemming from

a single alleged corrective disclosure.

In the current operative complaint, the plaintiffs' counsel has expanded the class period by two years, and increased the number of alleged corrective disclosures to three. These changes have driven exposure up by 43% to $35.2 billion, while the class period end date remains the same.[8]

Initial exposure against these two corporate staples of the U.S. economy amounted to $33.1 billion. According to amended allegations, claimed Exchange Act exposure now amounts to $68.4 billion.

Today, insurers of directors and officers face the gargantuan hurdle of controlling significant cost outlays and potential losses given the incentives of securities class action plaintiff and defense attorneys. Plaintiffs attorney awards are based on a percentage of the settlement amount, and legal defense fees are determined based on the complexity of the case.

Lawyers on both sides stand to attain significant economic benefits from exceedingly long class periods. Insurers can begin to control litigation costs by pressing counsel on poorly supported class period start dates in securities class actions that allege violations of the Exchange Act.

It is evident that directors and officers of publicly traded companies are operating under an increasingly challenging risk environment.[9] Primary carriers are suffering significant margin compression from unforeseen macroeconomic factors and multiforum Exchange Act and Securities Act class action litigation.

Carrier profitability has decreased given the significant rise in claim severity across the property and casualty market. “The key driver of severity in excess liability claims is the courtroom, where large corporations are often the targets of higher-than-normal awards, in part due to the influence of younger generations on juries who tend to support bigger judgments,” according to Alicja Grzadkowska at Insurance Business magazine[10]

The current low-yield environment has also forced the costs of reinsurance capital to increase. “Big losses from 2017 and 2018, increased primary insurance rates in the United States and elsewhere, increased demand for reinsurance and low interest rates suppressing investment income all factor into what are expected to be modest average reinsurance rate hikes,” according to Gavin Souter at Business Insurance.[11]

It has now become necessary for all professional executive liability practitioners — underwriters, claims professionals, brokers, agents and risk management professionals — to focus on being better informed and more knowledgeable about exposures in order to keep directors and officers apprised of changes in claim severity stemming from securities class actions.

Insurers of directors and officers are well served by tracking and evaluating changes in class period intervals to track claim severity throughout the securities class action litigation life cycle.

Aggregate damages and defense costs are correlated with the length of the operative class period due to the hourly billing structure of the legal profession. A claim with a longer class period creates a greater exposure and requires significantly greater resources to defend given the length of time that spans between the alleged misstatements and the corresponding alleged corrective disclosures.

The greater the interval between the alleged misstatements or omissions and the alleged corrective

disclosures, the more costly testing the relatedness among them becomes. Severing the link of relatedness is one sure way of limiting severity to reduce costs of defending securities class action claims.

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[1] In Khunt v. Alibaba Group Holding Limited et al.

[2] Timber Hill LLC v. The Kraft Heinz Company et al.

[3] Ibid.

[4] “GE shares fall on Madoff whistleblower calling its finances a fraud,” Reuters, Aug. 15, 2019 https://uk.reuters.com/article/us-ge-accounts/ge-shares-fall-on-report-that-cash-situation-worse-than-thought-idUKKCN1V519M.

[5] In re General Electric Securities Litigation.

[6] SAR SCA Claims Database.

[7] In Re Phillip Morris International Inc. Securities Litigation.

[8] SAR SCA Claims Database.

[9] “Risks facing directors and officers,” Financier Worldwide, October 2019, https://www.financierworldwide.com/roundtable-risks-facing-directors-officers-oct19#.XayBCndFxPZ.

[10] “Rise in claims severity puts a heavy burden on the insurance industry,” Insurance Business Magazine, June 28, 2019 https://www.insurancebusinessmag.com/us/news/breaking-news/rise-in-claims-severity-puts-a-heavy-burden-on-the-insurance-industry-171353.aspx.

[11] “Reinsurance buyers set to face more rate increases,” Business Insurance, Sept. 09, 2019 https://www.businessinsurance.com/article/20190909/NEWS06/912330567/Reinsurance-buyers-set-to-face-more-rate-increases.