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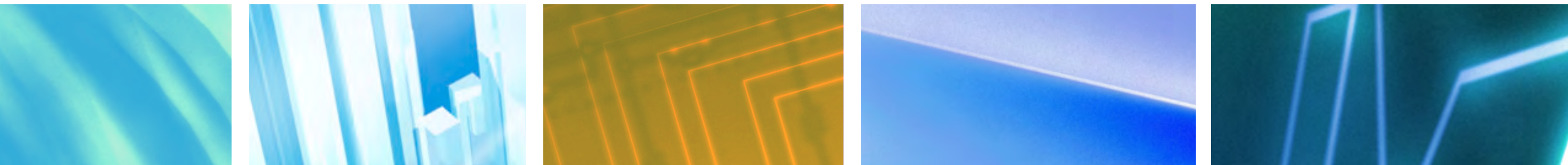
Considerations for Blow Provisions in Securities Class Action Settlements



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INTRODUCTION

Many securities class action settlement agreements include what is commonly referred to as a "blow provision." Blow provisions are structured to give defendants the option to terminate a conditional class settlement agreement if a specified threshold is reached in terms of investors opting out of the settlement (opt outs).[1] Without careful structuring, a blow provision may fail to give defendants the right to terminate or renegotiate a class settlement when opt-out exposure—the potential dollar amount of damages that opt-out investors may seek from defendants—reaches an unacceptable level relative to the initially agreed-upon settlement amount.

Ideally, a blow provision would be tied directly to the dollar amount of the potential exposure to opt outs. This potential exposure cannot be known with certainty, though, because opt-out plaintiffs may make different allegations in their litigation than the class action plaintiffs.[2] However, the provision can be structured based on a specified dollar value of potential claims so that it more closely relates to the potential dollar amount of opt-out exposure. Such a structure makes it more likely that defendants will be able to terminate the class settlement agreement before the exposure to opt outs has exceeded an unacceptable amount. A blow provision that is set at a specified dollar value of potential claims also has the advantage of less ambiguity about the calculation required in order to determine whether the provision has been triggered.

Other blow provision structures, such as those based on some percentage of shares, pose different and more problematic issues. They may lack a relationship to opt-out exposure because the actual number of shares purchased by class members is unknown at the time of settlement, damages per share may vary widely, and/or because the securities class action may involve securities other than common stock (for example, debt securities). Other blow provision structures can also make it difficult to know whether the provision has been activated. Failure to specify aspects of such other provisions' terms at the time of settlement may render the provision unworkable and/or ineffective.

Without careful structuring, a blow provision may fail in its intended purpose of allowing defendants to terminate or renegotiate a class settlement when opt-out exposure reaches an unacceptable level.

BLOW PROVISION STRUCTURES

Blow provisions are typically confidential,[3] so a comprehensive survey of their various structures and frequency of such structures is not possible. However, at least four types of blow provision structures have been observed: (1) the dollar amount of potential claims, (2) the percentage of shares purchased by class members, (3) the percentage of shares outstanding, and (4) the percentage of shares traded.

As previously noted, a blow provision based on the dollar amount of potential claims is most closely related to the dollar amount of potential exposure to opt outs. This makes it more likely that a defendant will be able to terminate the settlement agreement before the dollar exposure to opt outs exceeds an unacceptable amount. While the remaining structures are less closely related to the dollar amount of potential exposure to opt outs, there are considerations for each to reduce ambiguity in determining whether blow provisions have been triggered. These considerations are discussed below.

Dollar Amount of Potential Claims

This structure sets the threshold as a certain dollar amount of potential claims. Settlement notices typically lay out a formula for determining a "recognized loss" amount for each investor in terms of damages per share depending upon purchase and sale dates. The recognized loss amount is then used to distribute the total settlement on a pro-rata basis.[4] Blow provisions can be structured such that if the recognized loss amount for opt-out investors, calculated pursuant to the settlement notice, exceeds a particular dollar amount, the defendants have the right to terminate the settlement agreement.

One important benefit of this structure is that it is most closely tied to actual exposure to claims by opt-out investors. The recognized loss amount is generally calculated based upon the class action complaint or analysis by an expert retained on behalf of the class, and can serve as an estimate of what the opt-out investor(s) may potentially claim as damages.[5] It is also readily calculable for opt outs.

A structure based on the dollar amount of potential claims is most closely tied to actual opt-out exposure.

This structure is particularly beneficial for cases in which claimed damages per share differ significantly among class members, and thus may differ significantly among potential opt-out investors. For example, cases that involve numerous alleged corrective disclosures during the class period or claims under both Rule 10b-5 and Section 11.

Setting the blow provision threshold based on the dollar amount of potential claims may also be particularly beneficial in cases involving settlements that include securities other than common stock. In such cases, potential opt-out exposure may vary greatly depending upon the type of security for which the opt out is claiming damages.

Percentage of Shares Purchased by Class Members

Another observed threshold is the percentage of shares purchased by class members—shares purchased during the class period and damaged according to the recognized loss amount discussed above. This structure presents a number of issues.

As a primary matter, the number of shares purchased by class members cannot be known with certainty until the end of the claims process, when it is too late to exercise a blow provision. Therefore, for this threshold to be workable in practice, the parties need to specify an estimate of the number of shares purchased by class members at the time the blow provision is set.[6] However, there are currently no reliable ways to estimate this figure.[7] If the parties agree to an estimated number of shares purchased by class members at the time the blow provision is set, and use that to determine an acceptable percentage blow provision, the percentage blow provision may not ultimately track the parties' intentions if the actual number of shares purchased by class members turns out to be very different from the estimated number.

For example, assume the desired blow provision threshold is 5% of shares purchased by class members. If the agreed-upon estimated number of shares purchased by class members is 50,000,000, then defendants have the right to exercise the blow provision if the number of opt-out shares equals 2,500,000 or more. If the ultimate number of shares purchased by class members—as determined through the claims process—turns out to be only 25,000,000, then the blow provision as structured would have allowed almost 10% of class members to opt out before defendants could have exercised the blow provision.

Further, this threshold is less closely tied to potential exposure than the dollar amount of potential claims because the amount of potential damages may differ for each share purchase. Potential damages depend upon when the share was purchased and whether it was held throughout the class period or, if sold, when it was sold. Potential damages can vary dramatically in cases involving numerous alleged corrective disclosures during the class period or claims under both Rule 10b-5 and Section 11. Calculating blow provisions based on a percentage of shares purchased by class members does not take into consideration any variability in per-share damages.

Calculating blow provisions based on a percentage of shares purchased by class members does not take into consideration any variability in per-share damages.

Assuming per-share damages are the same across shares purchased by class members, one might consider setting a threshold based on the number of shares purchased by class members by dividing the maximum acceptable dollar amount of opt-out exposure by the maximum potential damages per share according to the class action complaint or analysis by an expert retained on behalf of the class.

For example, if defendants would like the right to exercise the blow provision if the estimated exposure to opt outs reaches $12.5 million, and assumed damages are $5.00 per share, then defendants may want to structure the blow provision such that it can be triggered if 2,500,000 or more damaged shares opt out. If per-share damages vary, one could still set such a threshold using maximum potential damages per share, which would be a relatively conservative estimate of exposure for each opt-out share.

Percentage of Shares Outstanding

Setting a blow provision threshold at a certain percentage of shares outstanding is another observed structure. Similar to the percentage of shares purchased by class members structure, this threshold is less closely tied to potential exposure than the dollar amount of potential claims because the amount of potential damages may differ for each damaged share. Setting aside this issue, the primary considerations in setting a percentage threshold when using this structure are that (1) the number of shares outstanding may vary over the course of the class period, and (2) the number of shares outstanding may be substantially higher than the maximum number of shares that could have been damaged.

The first issue is more easily dealt with. To avoid ambiguity, the point in time at which shares outstanding will be measured should be clearly specified. For example, the blow provision could be set as a specified percentage of the number of shares outstanding at the end of the class period. Alternatively, if a specific shares outstanding calculation is determined at the time of the settlement agreement, then the desired percentage can be applied directly to that figure, thereby determining up front the threshold number of opt-out shares that will trigger the blow provision.[8]

The second issue is more challenging. The number of shares outstanding often overstates the maximum number of shares damaged for a variety of reasons. For example, a large portion of shares outstanding could have been held throughout the class period by officers and directors who are not eligible for damages. A substantial portion of shares outstanding may also have been continuously held by institutional investors during the class period, and therefore not damaged.[9] While precise information on the amount of shares retained by institutional investors throughout the class period is unavailable, estimates using publicly available holdings data can be sizeable—at times greater than 50 percent of shares outstanding.[10] This information can be taken into account when setting a percentage threshold.

All else being equal, basing the calculation on the number of shares outstanding, without any adjustments for shares that likely did not trade during the class period, increases the likelihood that the blow provision will not be triggered before the exposure to opt-outs has exceeded an unacceptable amount.

For example, assume the desired blow provision threshold is 5% of the maximum number of shares that could have been damaged. If a defendant sets the blow provision as 5% of shares outstanding, and the agreed-upon number of shares outstanding is 100,000,000, the defendant has the option to terminate the settlement agreement if any one opt-out plaintiff, or opt-out plaintiffs in aggregate, owned 5,000,000 damaged shares or more. However, if half of the defendant company's shares are estimated to have been held over the class period by officers, directors, and/or institutional investors, then only 50,000,000 shares are potentially damaged. In this case, defendants would want to set the blow provision at 2.5% of shares outstanding: 2.5% of 100,000,000 shares outstanding equals 5% of 50,000,000 potentially damaged shares. Otherwise, defendants would not have the option to exercise the blow provision until 10% of the potentially damaged shares have opted out: 5% of 100,000,000 shares outstanding equals 10% of 50,000 potentially damaged shares.

A calculation based on the number of shares outstanding, without any adjustments for shares that likely did not trade during the class period, increases the likelihood that the blow provision will not be triggered before the opt-out exposure has exceeded an unacceptable amount.

In sum, if one simply assumes that shares outstanding is a good proxy for shares damaged, and no adjustment is made to the blow provision percentage, then the blow provision is likely to be set too high, increasing the likelihood that the blow provision will not be triggered when the exposure to opt outs becomes unacceptable.

Percentage of Shares Traded

A percentage of shares traded structure is one that ties the blow provision threshold to the volume of shares traded during the class period. Importantly, this structure can result in a blow provision that is set too high, increasing the likelihood that the blow provision will not be triggered when the exposure to opt outs becomes unacceptable. This is because the number of shares traded is an unreliable proxy for the number of shares purchased by class members.

One reason why the number of shares traded is not a good proxy for the number of shares purchased by class members is that intraday traders and market makers would not have been potentially damaged if they were buying and selling shares in the same day, yet these types of trades would be included in trading volume.[11] Trading volume could also reflect the same shares being traded frequently by a small number of investors, in which case the number of shares purchased by class members is not increasing. Failing to consider that trading volumes may include such trades would overstate potentially relevant trading volume, thereby creating a higher threshold for triggering the blow provision. However, as discussed above, there are currently no reliable ways to estimate which portion of shares traded represents shares purchased by class members.

Simply assuming that shares traded is a good proxy for shares damaged likely causes the blow provision to be set too high, increasing the likelihood that the blow provision will not be triggered when the exposure to opt outs becomes unacceptable.[12]

A structure based on the percentage of shares traded can result in a blow provision that is set too high.

CONCLUSION

Without careful structuring, a blow provision may fail in its purpose of allowing defendants to terminate or renegotiate a class settlement when opt-out exposure reaches an unacceptable level. Ideally, the blow provision would be directly related to the dollar amount of potential exposure to opt outs. While this potential exposure cannot be known with certainty, structuring the provision based on a specified dollar value of potential claims results in a provision that more closely relates to the potential dollar amount of opt-out exposure. This structure also has the advantage of less ambiguity regarding the calculation, making it more likely that any defendant will be able to terminate the settlement agreement before the exposure to opt outs has exceeded an unacceptable amount.

ENDNOTES

[1] For a comprehensive analysis of publicly available lawsuits and settlements of opt-out securities cases, see Amir Rozen, Brendan Rudolph, and Christopher Harris, *Opt-Out Cases in Securities Class Action Settlements: 2012–2014 Update*, Cornerstone Research and Latham & Watkins (2016).

[2] The lower bound of exposure is likely the amount the opt-out plaintiffs would have recovered through the class settlement. Presumably any opt-out plaintiffs expect to recover an amount greater than the amount they would have recovered through the class settlement. However, an inherent limitation in structuring blow provisions is that it is unknown whether an opt out's claim when refiled may produce a larger claim relative to that opt out's claim as part of the class, or whether such a claim would have a higher or lower settlement value.

[3] "The US Court of Appeals for the Eleventh Circuit examined a 'blow provision' granting the defendant the opportunity to withdraw from the class action settlement if an undisclosed number of class members opted out of the settlement. The court found that the number of opt outs required to trigger the blow provision could be kept confidential to encourage settlement and discourage third parties from soliciting class members to opt out. (*HealthSouth Corp. Sec. Litig., 334 Fed. Appx. 248, 250 & n.4 (11th Cir. 2009).*)" Gregory A. Markel, "Settling Class Actions: Process and Procedure," *Practical Law* (October 2013).

[4] See, for example, *In re BankUnited Securities Litigation*, Notice of Pendency of Class Action and Proposed Settlement, Settlement Fairness Hearing, and Motion for Attorneys' Fees and Reimbursement of Litigation Expenses, March 5, 2013, p. 8: "The term 'Recognized Loss' . . . is a calculation to arrive at a loss figure for purposes of calculating an Authorized Claimant's *pro rata* participation in the Net Settlement Fund."

[5] The recognized loss formula is agreed upon by plaintiffs and defendants and subject to court approval.

[6] Without such a specification it cannot be known whether the provision is blown unless the number of shares opting out is so large that it greatly exceeds the blow provision percentage of all shares outstanding, in which case it would likely also exceed the blow provision percentage of shares purchased by class members.

[7] Courts have criticized trading models that purport to estimate the number of damaged shares by predicting whether share trades during the class period are new shares entering the class or are trades of shares that have already entered the class (and when each share purchased was ultimately sold) as generally unreliable. See, for example, *Kaufman v. Motorola Inc.*, 2000 U.S. Dist. LEXIS 14627 (N.D. Ill. 2000) and *In re Broadcom Corporation Securities Litigation*, 2005 U.S. Dist. LEXIS 12118 (C.D. Cal. 2005).

[8] Further, in determining the desired percentage threshold, or desired threshold number of shares, defendants may consider using publicly available information about institutional holdings. For example, if defendants would like to have the option to terminate the settlement agreement if a certain number of the largest institutional investors choose to opt out, the blow provision threshold can take into consideration an estimate of the number of shares purchased by these institutional investors over the course of the class period. As noted below in endnote 10, 13F filings provide quarterly share holdings data for certain investors. An estimate of the number of shares purchased by these investors over the course of the class period can be calculated by summing any increases in quarterly share holdings for each investor over the course of the class period.

[9] Shares outstanding adjusted for such factors is also commonly referred to as "float," which refers to the number of a company's shares available for investors to trade. Float is typically calculated as the number of shares outstanding less shares held by company officers, directors, and/or other employees, or compensation programs for employees. Other adjustments are sometimes also made, for example, subtracting out long-term holdings by larger institutional investors.

[10] One potential way to estimate institutional holdings over the course of the class period is to use quarterly holdings data from 13F filings which certain investors are required to file with the U.S. Securities and Exchange Commission (SEC). Holdings at the beginning (and end) of the class period can be interpolated using the quarterly holdings data just prior to and just after the beginning (and end) of the class period and daily trading volume. These figures can then be compared to quarterly holdings during the class period, and the minimum amount of these figures can serve as an estimate of shares held by any individual institutional investor over the course of the class period.

[11] See, for example, John F. Gould and Allan W. Kleidon, "Market Maker Activity on Nasdaq: Implications for Trading Volume," *Stanford Journal of Law, Business and Finance* 1, no. 1 (1994), p. 13: "Our overall results show that, in virtually all of these cases, Nasdaq reported volume must be reduced by more than one-half to account for market maker activity."

[12] At a minimum, if this structure is used, to avoid ambiguity, it should be specified whether actual trading volume will be used or whether any adjustments to trading volume will be made. For example, it should be clearly stated whether there will be any reductions to trading volume to attempt to account for intraday traders and/or market makers.

ABOUT THE AUTHORS

Catherine J. Galley is a senior vice president in Cornerstone Research's Los Angeles office. She developed the firm's financial institutions practice, and has been active in the firm's securities and corporate and government investigations practices for more than 25 years. In addition, Ms. Galley has managed cases involving breach of contract, corporate governance, valuation, and auditor liability.

Erin E. McGlogan manages development initiatives for the firm's practice areas encompassing financial institutions, finance, and securities. She is based in Cornerstone Research's Los Angeles office, where she has over ten years of experiencing consulting on economic and financial issues in a variety of cases, including securities, finance, and financial institutions. Ms. McGlogan has deep expertise in securities cases addressing a broad range of claims and issues, such as Rule 10b-5, Section 11, damages, loss causation, materiality, and class certification.

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The authors request that you reference Cornerstone Research in any reprint of the information included in this publication. Please direct any questions to:

Catherine J. Galley, 213.553.2561, kgalley@cornerstone.com
Erin E. McGlogan, 213.553.2556, emcglogan@cornerstone.com

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