Rolling Disclosure Cap Method May Lead To Lower Damages

by Mark Howrey, Eric Korman and Emma Dong

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Mark Howrey


Eric Korman


Emma Dong

The Private Securities Litigation Reform Act established a cap on damages in cases brought under Section 10(b) of the Securities Exchange Act and Rule 10b-5.[1]

Historically, plaintiffs have typically calculated damages assuming this damages cap applies only to shares that are held through the final corrective disclosure in the class period, even if multiple corrective disclosures are alleged.

However, the U.S. District Court for the Northern District of California called into question that approach in the Zoom Securities Litigation.[2] When determining which of two potential investor lead plaintiffs had a greater financial interest in the litigation, the court applied the cap based on the closest corrective disclosure prior to the date on which the investor sold the security.

Utilizing the rolling disclosure cap methodology instead of the final disclosure cap could have a broad impact when calculating damages, and, in some cases, could reduce damages substantially.

In our analysis of 502 cases,[3] we found that the effect of applying the rolling disclosure cap reduces aggregate plaintiff-style damages[4] relative to the final disclosure cap for approximately two-thirds of the cases. Although the median reduction is only 3%, in approximately 8% of the cases, it amounts to more than 20%.

Below, we provide a brief background on the recent Zoom decision. Next, we describe how the Zoom decision can be applied to securities cases generally. Finally, we present our empirical analysis of the effect of alternative damages caps on aggregate plaintiff-style damages across our sample cases.

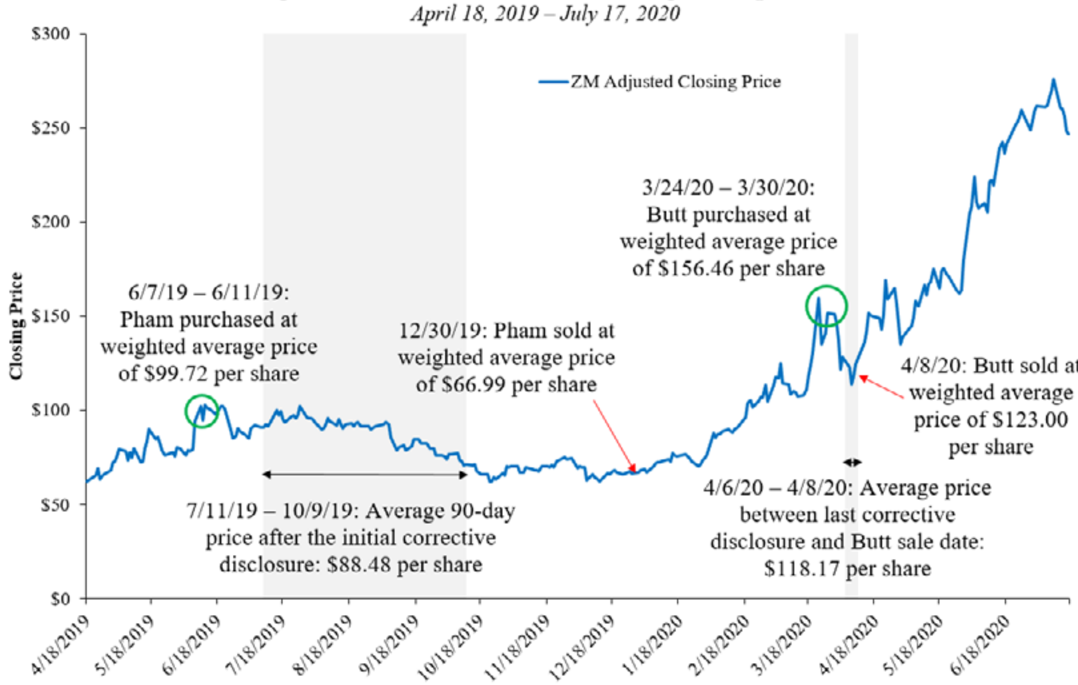
Overview of the Zoom Decision

In the Zoom securities matter, two investors, Tony Pham and Adam Butt, were both vying for lead plaintiff status. The court considered the financial interest for each investor as relevant for determining the appropriate lead plaintiff.

Both individuals presented their total losses, calculated as purchase amounts less sales amounts. While Pham reported larger total losses, the court found that this measure overstated his financial interest in the litigation.

Pham and Butt had different trading patterns, which are plotted in Figure 1.

Figure 1: Zoom Stock Price and Damages Comparison
April 18, 2019 – July 17, 2020



Pham reported a loss of $327,300, equal to his purchase cost less his sales proceeds.[5] Because Pham did not hold the security through the end of the class period, the final disclosure cap methodology would not apply to damages on the shares he purchased.

However, when determining which plaintiff had the greatest financial interest in the litigation, the court concluded that it would not consider losses that exceeded the statutory damages cap recoverable under the PSLRA.

When calculating losses recoverable under the PSLRA, the court applied the 90-day average price after the proceeding corrective disclosure on July 11, 2019, rather than the actual sales price.[6] This resulted in a total loss recoverable under the PSLRA of $112,400, which was $214,900 less than Pham's total loss of $327,300.[7]

Butt purchased shares in late March 2020, which he subsequently sold on April 8, 2020. He reported a loss of $209,517 on these transactions, based on his purchase and sale prices.[8] The court used the average price in the days following the final alleged corrective disclosure through his sale date to calculate total loss recoverable under the PSLRA.[9]

As this amount was higher than Butt's total loss, the damages cap did not apply. Using this analysis, the judge ruled that Butt, with losses of $209,517, had the most to gain from the lawsuit relative to Pham, with losses recoverable under the PSLRA of $112,400.[10]

In a later ruling, the court denied a request to reconsider based in part on the argument that only the last corrective disclosure should be used in calculating the damages cap under the PSLRA statute. In that decision, the court pointed out that the PSLRA statute makes no demand that the damages cap should only be calculated based on the final corrective disclosure.[11]

Description of the Rolling Disclosure Cap Methodology

In the Zoom decision, the court concluded that it was too early in the litigation to estimate the value of the damages the class might be able to recover with any precision, and it did not undertake an analysis of the impact of applying the rolling disclosure cap on aggregate damages.[12]

Beyond the scope of this case, a question arises as to whether applying the rolling disclosure cap would have a meaningful effect on damages. To explore this question, we compare estimates of aggregate damages to the class as a whole using the rolling disclosure cap and the final disclosure cap for a sample of 502 settled securities class actions.

To estimate damages for each case in our sample, we use the inflation per share on each day of the class period presented in the settlement plans of allocation. We then use a simplified plaintiff-style trading model to estimate trading behavior.[13] With this information, we calculate aggregate damages for each case using both the rolling disclosure cap and final disclosure cap methodologies.

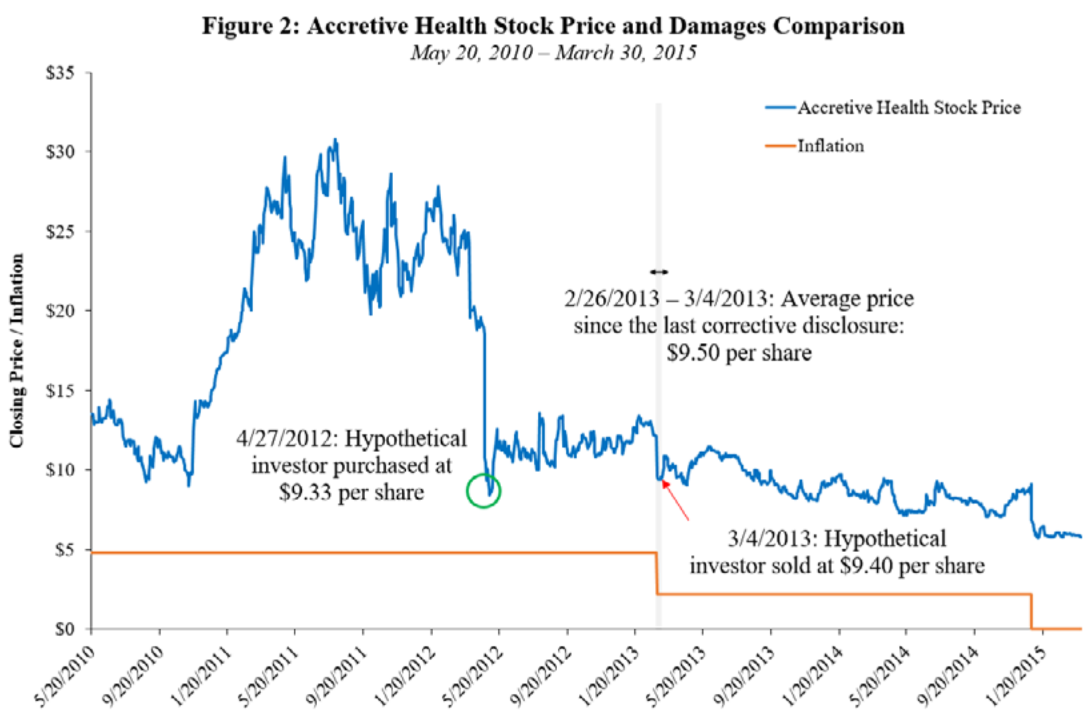
Under the rolling disclosure cap method, we identify the preceding corrective disclosure based on the decline in inflation per share over which a given purchaser held the security.

For purchases that were sold prior to the subsequent 90 days after the preceding corrective disclosure, we limit damages by the purchase price less the average close price between the corrective disclosure and sale date. For securities held through the 90 days, we use the average close price over the entire 90-day period.

For example, in the Hughes v. [Accretive Health Inc.](#) case in the [U.S. District Court for the Northern District of Illinois](#), plaintiffs allege two corrective disclosures: Feb. 26, 2013, and Dec. 30, 2014.[14]

The plan of allocation reflects this, with inflation of $4.83 per share from the beginning of the class period through the first corrective disclosure and $2.18 per share for inflation after the second disclosure through the end of the class period.[15]

Figure 2 presents the inflation per share and closing price for Accretive Health, along with the trades of a hypothetical class member that purchased Accretive Health stock



on April 27, 2012, for $9.33 per share and sold those shares on March 4, 2013, for $9.40 per share.

For this hypothetical investor, the final disclosure cap methodology would not apply because the investor did not hold through the end of the class period, and therefore damages per share would be the $2.65 difference in inflation per share at purchase ($4.83) less inflation per share at sale ($2.18).

However, because the average price between Feb. 27, 2013, the day after the corrective disclosure, and March 4, 2013, the date the hypothetical investor sold, was $9.50, above the $9.33 purchase price, this investor's damages are capped at $0 under the rolling disclosure cap methodology.

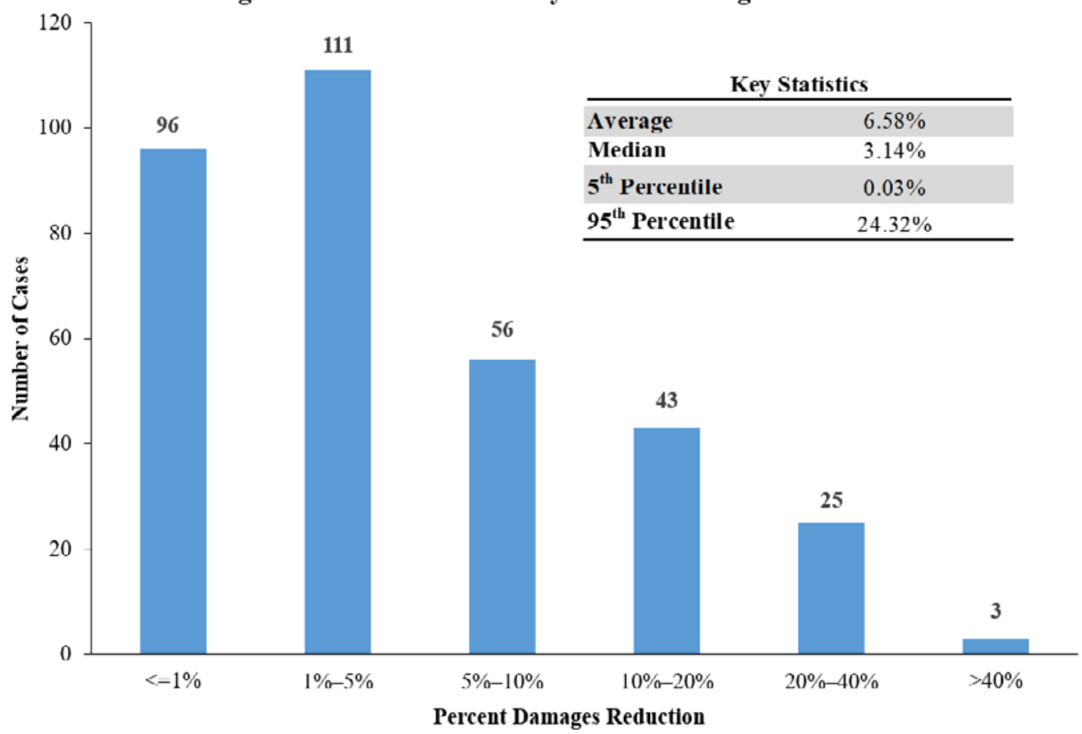
Overall Impact of the Rolling Disclosure Cap Methodology

Of the 502 cases examined, 145, or 29%, had only one corrective disclosure, and therefore damages would not be impacted by the choice of disclosure cap methodology. Additionally, 23 cases with multiple corrective disclosures had identical damages under the two methodologies. Thus, there is no difference in damages between the methodologies for approximately one-third of the cases examined.

For the 334 cases where there is a difference in aggregate damages, the median reduction in damages from using the rolling disclosure cap is 3% relative to the final disclosure cap.

However, the range is large. Figure 3 shows the distribution of the cases by the percentage of damages reduction after switching from the final disclosure cap to the rolling disclosure cap. For the majority of cases, the impact is less than or equal to 5%. However, we find that the reduction is greater than 20% for approximately 8% of the cases.

Figure 3: Number of Cases by Percent Damages Reduction



Conclusion

The recent Zoom decision has raised questions about the appropriate application of the PSLRA's statutory cap on damages. Practitioners should consider the potential reduction in damages achievable by implementing the rolling disclosure cap as an alternative to the final disclosure cap.

In our analysis of past securities matters, we find that the alternative approach reduces damages in approximately two-thirds of cases and, while the median reduction is only 3%, in certain cases, the reduction is much larger. Thus, in calculating damages, it will be important to understand the impact that the choice of methodology will have for the particular circumstances.

Mark Howrey is a managing principal, Eric Korman is a vice president, and Emma Dong is an associate at Analysis Group, Inc.

Analysis Group managing principal Nicholas I. Crew, vice president Kevin Gold, and senior analyst Minh-Quan Do contributed to this article.

Endnotes

1 Private Securities Litigation Reform Act of 1995, Public Law No. 104–67, 109 Stat. 737, December 22, 1995. https://www.govinfo.gov/content/pkg/PLAW-104publ67/pdf/PLAW-104publ67.pdf. "[T]he award of damages to the plaintiff shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the subject security and the mean trading price of that security during the 90-day period beginning on the date on which the information correcting the misstatement or omission that is the basis for the action is disseminated to the market. ...[I]f the plaintiff sells or repurchases the subject security prior to the expiration of the 90-day period described in paragraph (1), the plaintiff's damages shall not exceed the difference between the purchase or sale price paid or received, as appropriate, by the plaintiff for the security and the mean trading price of the security during the period beginning immediately after dissemination of information correcting the misstatement or omission and ending on the date on which the plaintiff sells or repurchases the security."

2 See In re: Zoom Securities Litigation, Case No. 20-cv-02353-JD (N.D. Cal.), Dkt. No. 56.

3 Our sample consists of 502 securities class action settlements between 2010 and 2019 with Rule 10b-5 claims on equity securities with nine or fewer dates where inflation decreased for which we had sufficient information to calculate aggregate damages using a plaintiff-style trading model.

4 Plaintiff-style damages assume defendants are found liable for claims. In addition, aggregate damages are calculated using a trading model to estimate purchase and sale behavior.

5 In re: Zoom Securities Litigation, Case No. 20-cv-02353-JD (N.D. Cal.), Pham Exhibit.

6 Ibid., Order, p. 4.

7 Ibid., Order, p. 4.

8 Ibid., Butt Exhibit.

9 Ibid., Order, p. 4.

10 Ibid., Order, p. 4.

11 See ibid., Order Re Reconsideration, April 12, 2021, p. 2.

12 Ibid., Order, p. 3.

13 Trading behavior is estimated using a simplified two-trader model that assumes that higher frequency traders account for hold 20% of shares available to trade (float), and that they account for 80% of daily volume. Lower frequency traders hold 80% of the float but account for 20% of the daily volume. For this simplified trading model, float is assumed equal to shares outstanding. Daily volume is reduced depending on the exchange on which the equity is listed. In this simplified trading model, we do not adjust for short interest, insider trades, or institutional holdings. While these models have been rejected by courts as being unscientific, they are often used in settlement negotiations.

14 For February 26, 2013, the complaint states, "[t]he truth began to come out on February 26, 2013, when, after the market close, Accretive issued a press release announcing that it was postponing the issuance of its financial results for 4Q 2012 and FY 2012 [...]" For December 30, 2014, the complaint states that "[n]early two years later, after a drawn out and expensive investigation, the entire truth about Defendants' accounting fraud was disclosed to the market on December 30, 2014, when Accretive finally issued its restated financial statements for the 2009–2012 period." See Hughes, et al. v. Accretive Health, Inc., et al., Case No. 13-cv-3688 (N.D. Ill.), Third Amended Complaint ("Accretive Health Complaint"), May 13, 2015, paragraphs 15 and 106.

15 See ibid., Notice of Proposed Settlement of Class Action, March 8, 2016, p. 7.