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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Drafting Blow Provisions In Securities Class Settlements

By **Catherine Galley and Erin McGlogan, Cornerstone Research**

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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.


Catherine Galley


Erin McGlogan

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. 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 exceeds 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.

Blow Provision Structures

Blow provisions are typically confidential, so a comprehensive survey of their various structures and the 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.

Dollar Amount of Potential Claims

This structure sets the threshold as a specified 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. Blow provisions can be structured such that if the recognized loss amount for opt-out investors, calculated pursuant to the settlement notice, exceeds a specified 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. It is also readily calculable for opt-outs.

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, such differences may exist in 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 investor 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. However, there are currently no reliable ways to estimate this figure.[2]

If the parties agree on an estimated number of shares, that estimate can be used to determine an acceptable percentage blow provision. However, the 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 estimate.

Further, this threshold is less closely tied to potential exposure than is the dollar amount of potential claims discussed above because the amount of potential damages may differ for each share purchased. Potential damages depend upon when the share was purchased, whether it was held throughout the class period, and, 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.

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.

Percentage of Shares Outstanding

Setting a blow provision threshold at a specified percentage of shares outstanding is another observed structure. This threshold is less closely tied to potential exposure than is 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 threshold for the percentage of shares outstanding are that (a) the number of shares outstanding may vary during the course of the class period and (b) the number of shares outstanding may be substantially higher than the maximum number of shares that may 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 threshold can 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 upfront the threshold number of opt-out shares that will trigger the blow provision.

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 may 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. Although precise information on the number of shares retained by institutional investors throughout the class period is unavailable, estimates based on publicly available holdings data indicate that it can be sizable — at times greater than 50 percent of shares outstanding. This information can be taken into account when setting a percentage of shares outstanding 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 exceeds an unacceptable amount.

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. This structure can also 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 occurs because the number of shares traded is an unreliable proxy for the number of shares purchased by class members.

For example, intraday traders and market makers are not potentially damaged if they buy and sell shares within the same day, yet these types of trades are included in trading volume. Trading volume may 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 does not increase. Failing to consider that trading volumes may include such trades overstates the potentially relevant trading volume, thereby creating a too-high threshold for triggering the blow provision. However, as discussed above, there are currently no reliable ways to estimate the portion of shares traded that 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 reaches an unacceptable level.

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. Although 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 exceeds an unacceptable level.

Catherine 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.

Erin McGlogan is manager of practice area development in Cornerstone Research's Los Angeles office. She manages development initiatives for the firm's practice areas encompassing financial institutions, finance and securities.

This article is a condensed version of "Considerations for Blow Provisions in Securities Class Action Settlements."

[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] U.S. courts have criticized trading models that purport to estimate the number of damaged shares by predicting whether shares traded during the class period were new shares entering the class or shares that had 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).
