Considerations for Blow Provisions in Securities Class Action Settlements

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INTRODUCTION

Securities class action settlements often include what is commonly referred to as a "blow provision"—a provision designed to give defendants the option to terminate the settlement agreement if a specified threshold of investors opt out of the class action settlement ("opt-outs").[1]

Ideally, a blow provision would be tied directly to anticipated opt-out exposure, that is, the amount of damages expected to be claimed by opt-outs if or when they file their own direct action suits. However, opt-out exposure often cannot be known at the time of the class action settlement. For example, opt-out plaintiffs may not yet have filed direct action lawsuits by the time a blow provision would need to be invoked. Further, opt-out plaintiffs may ultimately plead different allegations from those asserted by the class action plaintiffs.[2] Due to this limitation regarding the information available to assess opt-out exposure, parties to a class action settlement instead must structure blow provisions based on other methods.

> Blow provision: a provision designed to give defendants the option to terminate the settlement agreement if a specified threshold of investors opt out of the class action settlement.

If the terms of a blow provision are not specified with care, there may be ambiguity or disagreement as to whether the blow provision has been triggered. This article discusses certain blow provision structures that have been observed in practice, as well as details regarding specifications that parties can bear in mind to reduce ambiguity when crafting blow provisions.

Parties to a class action settlement often wish to keep blow provision terms confidential for various reasons, for example, to encourage participation in the class action settlement or to conceal the threshold required to "blow" the settlement from third parties who might try to use that information to recruit potential opt-outs.[3] Thus, the specific terms of blow provisions are often not publicly disclosed,[4] rendering a comprehensive empirical survey of various blow provision structures infeasible. Nonetheless, this article discusses certain blow provision terms that have eventually become publicly available.

A "DOLLAR AMOUNT OF CLAIMS" STRUCTURE OFFERS CERTAIN BENEFITS

One approach to structuring a blow provision that has been observed in practice is to specify a dollar amount of claims as the threshold to "blow" the class action settlement. As discussed below, this "dollar amount of claims" structure reduces ambiguity and potential for disagreement between the parties, and it is therefore the authors' recommended approach.

This "dollar amount of claims" structure is typically based on a calculable amount of dollar claims that opt-outs would have if they had remained in the class action settlement.[5] Class action settlement notices, and/or the associated plans of allocation, typically lay out a formula for determining a so-called "recognized loss" amount for each investor in the class, usually expressed in terms of damages per share based on the investor's purchase and sale dates.[6] The recognized loss amount is used to distribute the total settlement fund on a pro-rata basis to investors deemed to have a valid claim.[7] Blow provisions can be (and sometimes are) structured based on recognized loss amounts. Such a structure affords defendants the right to terminate the class action settlement agreement if the calculated total recognized loss amount for all opt-outs exceeds a particular dollar threshold.

One important benefit of this structure is that the dollar amount of claims under the recognized loss formula is readily calculable and unambiguous when an opt-out's trading records are available. The "dollar amount of claims" structure can be particularly beneficial for cases where the recognized

loss amount for a given number of shares purchased varies significantly across investors depending on when they purchased and sold their shares, for example, cases with numerous alleged corrective disclosures, or cases involving allegations under both Rule 10b-5 and Section 11.

Another benefit of the "dollar amount of claims" structure is that the recognized loss amount might conceptually be thought of as a lower bound estimate of anticipated opt-out exposure. From an economic perspective, while the actual amount that opt-out investors may ultimately receive in settlement or judgment in their own direct action is unknown, such investors presumably ***expect to*** recover more via the direct action than through the class action settlement. If they expected to recover less by opting out, then it would have been economically better for them to remain in the class action settlement.

Blow provisions based on the dollar amount of claims have been observed among the limited publicly available information on such provisions, including *In re Prudential Securities Inc. Ltd. Partnerships Litigation* and *In re Petrobras Securities Litigation*. In the *Prudential* matter, the blow provision threshold was set at a specific dollar amount of opt-out claims ($10 million).[8] In the *Petrobras* matter, the blow provision threshold was set to trigger if opt-out "recoverable losses" exceeded a specific dollar amount ($832 million) that reflected 5% of the aggregate "class damages estimated" by plaintiffs' expert.[9]

OTHER TYPES OF BLOW PROVISION STRUCTURES

Several other types of blow provision structures, not based on recognized loss amounts, have also been observed in practice. While these structures do not offer the same benefits as the "dollar amount of claims" structure, they can nonetheless be specified in order to reduce ambiguity as to whether the blow provision has been triggered.

"Damaged Shares" Structure

One such structure sets the threshold to "blow" the class action settlement based on the number of "damaged shares" (i.e., shares purchased during the class period and held over at least one corrective disclosure).[10] Often, the blow provision threshold is based on a ***percentage*** of damaged shares that opt out. However, the parties adopting a "percentage of damaged shares" threshold need to be precise in specifying the details and components of the percentage calculation to avoid subsequent disagreements regarding whether the blow provision threshold has been triggered.

In re TerraForm Global Inc. Securities Litigation provides a rare public example of a securities class action settlement that was jeopardized by ambiguity in the blow provision structure. The blow provision in the *TerraForm Global* matter was set to trigger if investors that accounted for more than 5% of class-wide damaged stock purchases opted out of the settlement. However, a disagreement arose because the parties did not stipulate the date range over which the total number of damaged shares (the denominator in the percentage calculation) would be estimated. This lack of specificity in the methodology for calculating the blow provision generated substantial ambiguity that hampered TerraForm Global's efforts to terminate the class settlement. A review of public press indicates that the parties eventually renegotiated a lower settlement amount without formally terminating the original settlement agreement.[11]

> The "dollar amount of claims" structure reduces ambiguity and potential for disagreement between the parties.

One way to reduce ambiguity in a blow provision based on damaged shares is to simply specify a threshold of the minimum ***number*** of damaged shares that opt out instead of using a ***percentage*** threshold. Even if the parties have a percentage rule-of-thumb in mind—for example, in our experience the 5% threshold is fairly commonly observed in blow provisions (as also seen in the public *TerraForm Global* and *Petrobras* examples)—translating the desired percentage into a concrete number of shares helps remove ambiguity.

Other types of observed blow provision thresholds include those based on a percentage of shares outstanding or on a percentage of total shares traded during the class period. Such structures are similar to the "damaged shares" structure discussed above but utilize a different denominator. These structures also run the risk of introducing substantial ambiguity into the blow provision threshold calculation.

"Shares Outstanding" Structure

There are two primary considerations in setting a percentage threshold using a "shares outstanding" structure. First, the number of shares outstanding may vary during the class period. This issue is easily addressed by specifying the point in time at which shares outstanding will be measured. 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 (effectively creating a fixed share number as the threshold).

The second, and more challenging, consideration is that the number of shares outstanding may be substantially higher

than the maximum number of damaged shares 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 generally ineligible to submit claims in a securities class action settlement. Alternatively, a substantial portion of shares outstanding may have been purchased by institutional investors prior to the class period and held throughout the entire class period (i.e., these shares could not have been purchased at inflated prices during the class period). While precise information on the number of shares continuously held by institutional investors throughout the class period is usually unavailable, publicly available quarterly institutional holdings data indicate that such holdings can be sizeable, at times greater than 50% of shares outstanding.[12] If the parties prefer a blow provision structure based on shares outstanding, the percentage threshold should be set taking into account information on officer and director holdings and shares held by institutional investors.

"Total Shares Traded" Structure

A "total shares traded" structure ties the blow provision threshold to the aggregate volume of shares traded during the class period. This formulation can result in a blow provision that is set at a higher level than certain parties may desire because it does not provide a reliable proxy for, and typically overstates, the number of damaged shares.

For example, intraday traders and market makers are generally not damaged in securities cases if they buy and sell shares within the same day,[13] but these trades are still included in total reported daily trading volume (i.e., total shares traded).[14] Further, total trading volume during the class period may also reflect the same shares being traded frequently by a small number of investors between alleged corrective disclosures. Such trading volume typically would not be associated with positive dollar damages,[15] but the traded shares would nonetheless be included in the denominator for the blow provision threshold.

> Reduced ambiguity in the terms of a blow provision makes it more likely that defendants can terminate the settlement agreement if anticipated opt-out exposure reaches an unacceptable amount.

At a minimum, if a "shares traded" blow provision structure is used, to avoid ambiguity it should be clearly stated whether actual trading volume will be used or whether any reductions to trading volume will be made.

In sum, blow provision structures that rely on a percentage of damaged shares, a percentage of shares outstanding, or a percentage of shares traded—without considering the nuances discussed above—will generally introduce greater risk of disagreement between the parties as to whether the blow provision has been triggered and may misalign the actual blow provision threshold with the intentions of the parties.

CONCLUSION

Without careful structuring and precision in specifying the details and components of the threshold calculation, a blow provision may fail in its purpose of allowing defendants to terminate or renegotiate a class settlement if anticipated opt-out exposure reaches an unacceptable level. While opt-out exposure often cannot be known at the time a blow provision is written, structuring the blow provision based on a specific dollar value of opt-out claims has the advantage of less ambiguity. Blow provisions with the other structures discussed in this article may also be constructed in ways that can reduce (but may not eliminate) ambiguity. All else equal, reduced ambiguity in the terms of a blow provision makes it more likely that defendants can terminate the settlement agreement if opt-out exposure reaches an unacceptable amount.

ABOUT THE AUTHORS

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The views expressed herein are solely those of the authors and do not necessarily represent the views of Cornerstone Research.

ENDNOTES

[1] For a comprehensive analysis of publicly available lawsuits and settlements of opt-out securities cases, see Matt Osborn, Brendan Rudolph, and Christopher Turner, *Opt-Outs in Securities Class Action Settlements: 2019–H1 2022 Update*, Cornerstone Research and Latham Watkins (2023).

[2] An inherent limitation in structuring blow provisions is that it is unknown *ex ante* whether an opt-out's allegations will produce larger estimated damages relative to that opt-out's claims as part of the class, or whether the opt-out's allegations would have a higher (or lower) settlement value.

[3] See, for example, Gregory A. Markel, "Settling Class Actions: Process and Procedure," *Practical Law*, October 2013, citing to *HealthSouth Corp. Securities Litigation*, 334 Fed. Appx. 248, 250 & n.4 (11th Cir. 2009) ("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.").

[4] For example, a 2019 order preliminarily approving a settlement of *In re RH Inc. Securities Litigation* merely noted that "RH has the right to terminate the Settlement if valid requests for exclusion are received from persons and entities entitled to be members of the Class in an amount that exceeds an amount agreed to by Lead Plaintiffs and RH." Order Preliminarily Approving Settlement and Providing for Notice, *In re RH Inc. Securities Litigation*, June 21, 2019, p. 23.

[5] Some claims may ultimately be rejected by the claims administrator. Therefore, the dollar amount of submitted claims—that is, a concrete figure that is knowable at the time of the class action settlement hearing—could alternatively be characterized as "potential" or "submitted" claims. For the sake of simplicity, however, the phrase "claims" is used throughout this article to refer to submitted claims rather than to claims that eventually survive the full claims administration process.

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

[7] See, for example, Notice of (1) Proposed Class Action Settlement; (2) Settlement Hearing; and (3) Motion for an Award of Attorneys' Fees and Litigation Expenses, *In re Twitter Inc. Securities Litigation*, August 25, 2022, p. 9 ("Based on the formula stated below, a 'Recognized Loss Amount' will be calculated for each purchase of Twitter common stock during the Class Period that is listed on the Claim Form and for which adequate documentation is provided.").

[8] Opinion, *In re Prudential Securities Inc. Ltd. Partnerships Litigation*, February 1, 1996, p. 3 ("It was stipulated as part of the proposed Settlement that if $10 million in claims excluded themselves by opting-out from the Settlement proposed, Prudential had the right to walk away from the $110 million Settlement.").

[9] Memorandum Order, Supplemental Agreement, Amended Supplemental Agreement, and Attorneys' Fees Letter and Exhibits A–C, *In re Petrobras Securities*, February 6, 2018, Supplement Agreement, pp. 1–2, Amended Supplemental Agreement, pp. 1–2 ("Pursuant to paragraph 62 of the Stipulation, the Petrobras Defendants shall have, in their sole and absolute discretion, the option to terminate the Stipulation if members of the Settlement Class that, in the aggregate, have transactions resulting in Recoverable Losses (as defined in the Plan of Allocation) equal to or greater than 5% of the class damages estimated by [plaintiffs' expert], or US$831,740,713, validly request exclusion from the Settlement Class.").

[10] Structures based on the percentage of damaged shares were utilized in both *Welch v. Pacific Coast Oil Trust et al.* and *In re TerraForm Global Inc. Securities Litigation*. In the *Pacific Coast Oil Trust* case, the blow provision was initially kept confidential until the parties submitted a supplemental filing to the court. This supplemental filing disclosed that the blow provision threshold would trigger if holders of 1.5 million units opted out, or about 4.5% of the 33.3 million units that plaintiffs' expert estimated were held by class members. See Daniel Siegal, "$7.6M Oil Investor Settlement Wins Over Skeptical Judge," *Law360*, August 19, 2016. See also Dean Seal, "TerraForm Global Wants Option to Terminate $57M Settlement," *Law360*, August 23, 2018; Dean Seal, "Investors Say TerraForm Can't Use Option to Kill $57M Deal," *Law360*, November 2, 2018.

[11] See Dean Seal, "TerraForm Global Wants Option to Terminate $57M Settlement," *Law360*, August 23, 2018; Dean Seal, "Investors Say TerraForm Can't Use Option to Kill $57M Deal," *Law360*, November 2, 2018; Pete Brush, "TerraForm Gets OK for $49M SunEdison-Related Settlement," *Law360*, February 25, 2020.

[12] 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 daily trading volume and the quarterly holdings data just prior to (and just after) the beginning (and end) of the class period. 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.

[13] This is due to the fact that per share damages in securities class actions are typically calculated on a closing price basis, and typically do not fluctuate intraday.

[14] 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.").

[15] If, for example, the recognized loss formula specifies constant inflation between alleged corrective disclosures, then trading in-and-out between alleged disclosures will not generate positive dollar damages.