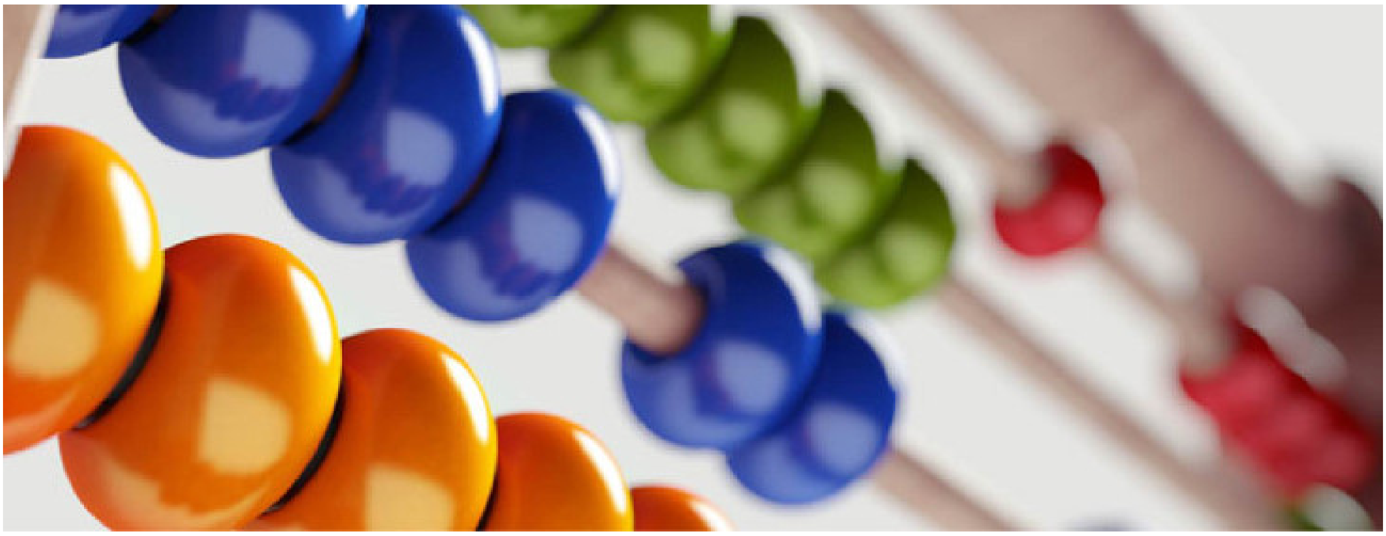

Economic Analysis in UK Shareholder Group Actions

RONNIE BARNES · CORNERSTONE RESEARCH

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With very few large-scale shareholder group actions having been filed in the United Kingdom, Ronnie Barnes, principal at Cornerstone Research in London, outlines the key elements of a typical US economic analysis in order to consider what differences might be needed in a UK context.

Only three significant cases have been brought by groups of shareholders of listed companies in the United Kingdom to date: the *RBS Rights Issue Litigation*, the *Lloyds/HBOS Litigation* and a claim against **Tesco**.

This is despite the 2010 United States Supreme Court ruling in *Morrison v National Australia Bank* (which effectively prohibited purchasers of securities on foreign exchanges from bringing lawsuits in the United States against the issuers of those securities) and the increasing importance of third-party funders to the litigation landscape.

Consequently, any consideration of the role of economic analysis in the assessment of certain elements of such cases—and , in particular, of the extent to which the types of analysis commonly undertaken in the context of US class actions will be relevant to the UK setting—is by definition of a speculative nature.

RELIANCE

At the class certification stage in the US, economic analysis plays a key role in addressing questions of reliance. Specifically, under the 'fraud-on-the-market' doctrine, there is a presumption of (indirect) reliance if the market in which the shares in question trade can be shown to be 'informationally efficient'. The most important test of whether the shares trade efficiently is to determine if a cause-and-effect relationship between new, value-relevant information and stock price movements can be established.

In almost all cases, this is assessed by means of an event study (a widely used and generally accepted tool from financial economics that examines the relationship between the public release of information and share price movements) that allows estimated market and industry effects to be removed in an effort to isolate company-specific changes.

Moreover, the US Supreme Court's 2014 ruling in *Halliburton II* established that defendants can rebut claims of indirect reliance if they can establish that the alleged misrepresentations did not affect the share price of the company in question, i.e., that the alleged misrepresentations had no 'price impact'. An event study is also an important tool for establishing price impact or lack thereof.

Establishing individual reliance is also required under Section 90A (albeit not s.90) of the Financial Services Market Act 2000 (FSMA). However, the opt-in nature of group litigation orders (GLO) in the UK (as compared with the opt-out nature of US class actions) raises questions regarding the need for an indirect demonstration of reliance. To the extent that establishing individual reliance is in fact required, there will almost inevitably be the need for a robust and rigorous economic analysis, including an event study.

Another interesting issue is whether the damages approach needs to be addressed when the GLO is sought. While the need to identify the common issues of fact or law that are likely to arise in the litigation is clear, the need to identify an approach to damages attributable to the allegations that can be applied to all members of the group is less so.

In *Comcast v Behrend* (2013), the US Supreme Court noted that "a model purporting to serve as evidence of damages in this class action must measure only those damages attributable to [plaintiff's liability] theory… A model that does not attempt to measure only those damages attributable to [plaintiff's liability] theory cannot establish that damages are susceptible of measurement across the entire class… Plaintiffs must put forward a damages methodology, 'consistent with its liability case,' that is both 'sound' and 'produce[s] [a] commonality of damages'". Whether a similar requirement will apply in the UK remains to be seen.

MATERIALITY

While neither s.90 nor s.90A of FSMA contains an explicit 'materiality'requirement, it seems likely that this will be needed to establish a claim in practice. In this case, the event study may again be a useful tool. There is no bright line in the US for what is material to investors, and facts considered immaterial by an issuer (and its auditors) for the purposes of financial statement disclosure may nevertheless be viewed as material to investors—and vice versa.

However, the US Supreme Court in *Basic Inc. v Levinson* (1988) defined materiality as “a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information made available”.

One way of assessing whether this is the case is to use an event study to examine the statistical significance of the share price changes (adjusted for market and industry effects) when the alleged misrepresentation and/or the so-called corrective disclosure is made. A finding that these changes are not statistically significant (loosely speaking, indistinguishable in a statistical sense from zero) is consistent with a conclusion that the alleged misrepresentation or omission is in fact not material.

DAMAGES AND LOSS CAUSATION

One group of commentators has observed that the “FSMA does not specify the basis on which damages arising under ss.90 or 90A will be calculated, and the question has not received any significant judicial treatment to date. This is a complex and difficult area.” In both the *RBS Rights Issue Litigation* and the *Tesco* claim, claimants advanced four possible measures of damages.

One of these is the same as the primary measure often used in the US—the ‘out-of-pocket measure’ or ‘price inflation’, i.e., the difference between the price paid and the true value of the security at the time of the initial purchase by the defrauded buyer.

More precisely, and subject to certain limitations, damages are often calculated as the difference between the price inflation on the purchase date and any inflation on the sale date. Once more, an event study (together with other techniques from financial economics such as discounted cash-flow analysis) is potentially useful in assessing the degree of price inflation at various points in time.

In the US, following the 2005 Supreme Court decision in *Dura Pharmaceuticals v Broudo*, recoverable damages are also limited by the losses caused by the disclosure of allegedly corrective information. Stock price declines resulting from alleged corrective information should be separated from those declines attributable to other contributing forces, such as “changed economic circumstances, changed investor expectations, new industry-specific or firm-specific facts, conditions, or other events, which taken separately or together account for some or all of that lower price,” the court said. This consideration of loss causationis perhaps best illustrated by means of an example.

Suppose that an investor purchases shares in ABC Plc at a price of GBP 24 per share at a time when the company has publicly misrepresented the state of its order book. Economic analysis has determined that had the misrepresentation not been made, the ‘true value’ of a share in ABC Plc would have been GBP 20, meaning that inflation at the time of purchase amounted to GBP 4 per share.

Several months later, the true state of the company’s order book is revealed and the share price falls from GBP 17 to GBP 15, of which GBP 0.50 is revealed (via an event study) to be attributable to market-wide and industry factors. The investor sells immediately after this corrective disclosure, meaning that there is no inflation at the time of sale.

Without taking loss causation into account, the investor would be entitled to damages of GBP4 per share. However, when loss causation is considered, recoverable damages – using the US approach – will be only the GBP1.50 per share that can be attributed to the corrective disclosure. Whether loss causation will in fact be relevant for determining damages in the UK remains to be seen – to the extent it is, the event study approach will again be paramount.

This article was adapted and updated from 'The Role of Economic Analysis in U.K. Shareholder Actions', by Cornerstone Research authors Kristin Feitzinger, Amir Rozen and Ronnie Barnes. The views expressed in this article are solely those of the author, who is responsible for the content, and do not necessarily represent the views of Cornerstone Research.'