Securities litigation gathers momentum in the UK

Clifford Chance's Ian Moulding, Chris Yates, Jason Epstein and Ryan Byrne consider the rising tide of US-style 'stock drop' shareholder class actions in the UK, and offer practical tips for in-house counsel on managing the risk of shareholder litigation

Shareholders can bring claims against listed companies to recover losses suffered as a result of a drop in the price of their shares (a 'stock drop'), often caused by a corporate scandal or other misfeasance being revealed to the market.

The shareholder class action brought against The Royal Bank of Scotland by investors who had bought shares in RBS' rights issue in 2008 (known as the Rights Issue Litigation) represented a watershed moment in the development of UK securities litigation. Although it settled on the eve of trial, the Rights Issue Litigation was the proof of concept: it is possible to successfully pursue high-value, complex shareholder class actions to trial (or, at least, settlement) under the UK's legal and procedural framework.

Since then, we have seen the UK's shareholder litigation market take off, with claims being brought against Lloyds and Tesco, and many more are understood to be in pre-action.

Our disputes practice has not only witnessed this uptick in securities litigation in the UK, but also across Europe, Asia and Australia. For example, in Germany and the Netherlands, investors are seeking compensation from Volkswagen for failing to disclose the company's alleged manipulation of emissions tests. Cases of a similar nature have recently been brought against Fortis/Ageas in the Netherlands, Bankia in Spain, Saipem in Italy, Toshiba in Japan, and AMP in Australia.

Securities litigation is well established in the US, where there is a sophisticated claimant industry that has developed over the past few decades in order to bring claims against listed companies. Many of these claims end in lucrative settlements, yielding significant profits for the lawyers and funders, as well as compensation for investors.

The development of a US-style claimant industry in the UK poses a serious risk to issuers of listed securities and their directors and senior managers. Liability for a corporate issuer will turn on the extent of directors' knowledge of untrue or misleading statements made by the company in its public statements. This puts directors' state of mind and conduct at the heart of claims and potentially exposes them to personal liability.

What is driving the rise in shareholder litigation?

The rise in shareholder litigation globally in recent years can be traced back to the 2010 US Supreme Court decision in *Morrison v National Australia Bank*. This case limited the extra-territorial effect of US securities legislation and restricted the ability of investors to bring claims against issuers listed outside of the US under the favourable and well-established US regime. This has perhaps encouraged investors to pursue claims elsewhere.

In the UK market, although a legal framework for shareholders to bring claims against issuers of listed securities was put in place almost two decades ago, a number of recent developments in the UK litigation market have made these types of class action claims increasingly attractive to potential claimants.

Third-party litigation funding: a deep, liquid third-party litigation funding sector has developed in the UK, having grown exponentially over the last decade – assets under management of the UK's largest funders stood at £1.5bn in 2018, up from just £180m in 2009.

The major litigation funders have identified shareholder class actions as an area for investment and are actively pursuing potential claims at the first sign of share price volatility following corporate scandals or regulatory issues.

For example, in October last year, shareholders in the UK's Patisserie Valerie saw their investments wiped out after the company

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admitted to serious accounting irregularities that left a £40m hole in its balance sheet. Within days, a claimant law firm was canvassing institutional shareholders to join a class action against Patisserie Valerie to recover their losses, and were already on the verge of securing third-party litigation funding.

This example encapsulates the current state of the UK securities litigation market. Investors whose shares fall in value are looking to recover those losses from companies through shareholder class actions. For their part, funders are attracted by the potentially significant returns and are willing and able to back such claims.

Third-party funding is integral to the ability of shareholders to bring claims because it allows them to participate in claims without having to contribute to the costs. Where shareholders are funds that owe duties to their own shareholders, the case for participating in these claims is even harder to resist.

Group Litigation Orders: GLOs are a case management tool available in the English courts that provide a straight forward 'opt-in' procedure for claimants to join a class action. This is particularly effective for encouraging retail investors to join a claim. The RBS Rights Issue Litigation (where there were 9,000 claimants), and the Lloyds/HBOS case, are prime examples of the successful use of GLOs in shareholder disputes.

'After the Event' insurance: ATE insurance products cover the claimant's liability to pay the defendant's costs if the claim is unsuccessful. This, together with third-party litigation funding, has reduced the notional downside of bringing high-value and complex shareholder claims as much (if not all) of the costs exposure associated with an unsuccessful claim has been shifted onto the funders and insurers.

Specialist claimant law firms and claims managers: Claimant law firms have long been a feature in the US securities litigation market and are now driving many of the UK's group actions. These firms can take the lead in co-ordinating claims, reaching out to prospective claimants, arranging the funding and insurance coverage, and then conducting the claim. Claimant firms can operate under conditional fee agreements, and so are incentivised to pursue claims to trial or settlement.

Alongside the law firms, claims managers specialising in group litigation have emerged in the market. These firms monitor the stock market to identify opportunities for shareholder class actions on behalf of institutional investors.

What options are available to shareholders to sue listed companies?

Sections 90 and 90A of the Financial Services and Markets Act (FSMA) 2000 are the primary mechanisms available to shareholders to bring claims against issuers for untrue or misleading statements or omissions.

Section 90 of FSMA creates liability for issuers and their directors to pay compensation to investors who have acquired any of the company's shares and suffered a loss in respect of them as a result of an untrue or misleading statement in, or omissions from, a listing particulars (eg an equity prospectus).

The RBS Rights Issue Litigation concerned claims brought under s90 of FSMA alleging that the prospectus that accompanied the £12bn rights issue in 2008 misrepresented RBS' financial position in the context of the global financial crisis and the acquisition of ABN AMRO.

Section 90A of FSMA requires an issuer to compensate investors where they have acquired, continued to hold, or disposed of shares in the company in reliance on public statements (typically Annual

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Reports), and suffered a loss in respect of those shares as a result of an untrue or misleading statement, or dishonest omission, by the issuer.

The ongoing Tesco litigation concerns claims brought under s90A of FSMA alleging that Tesco issued false and misleading statements to the market (in its annual reports, trading updates and profits statements), or omitted matters of material fact, concerning Tesco's financial position and prospects.

Unanswered questions

Sections 90 and 90A of FSMA raise a wealth of complex legal questions, but there is little English case law to provide the answers.

No case brought under either s90 or s90A of FSMA has reached judgment. This lack of guiding precedent creates considerable uncertainty for all parties as to how an English court will interpret and apply the legislation. Fundamental issues, such as the way in which damages are to be calculated, will need be resolved by the English courts in due course.

English courts may well look across the Atlantic to the well-developed body of US securities litigation for guidance. Analogous provisions have existed in the US since the passage of the Securities Act of 1933 and the Securities and Exchange Act of 1934. These provisions have been extensively litigated in the US over the last 40 years and have settled many of the key questions with which the English courts are yet to grapple.

For example, a key feature of US securities litigation is the 'fraud on the market' theory. This creates a presumption that investors have relied on the company's misstatements or omissions in making their investment decisions. This reduces the evidential burden on claimants and so makes bringing shareholder class actions significantly easier than if investors were required to prove that they actually relied on untrue or misleading statements or material omissions by the company (which appears to be the position under s90A of FSMA).

US securities litigation also has a highly sophisticated regime for calculating the loss suffered by investors as a result of stock drops, including capping damages where the share price has 'bounced back' in the period following the stock drop. The starting point is that investors are entitled to recover the difference between the price paid for securities and their true market value. Claimants in the UK may be able to claim greater amounts under s90A of FSMA because the deceit measure of damages for such claims might enable them to recover all losses flowing from the alleged fraud.

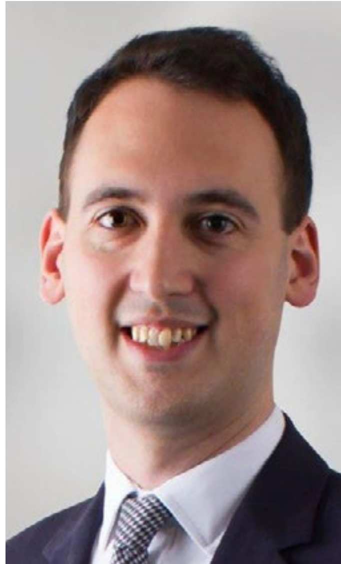
The English courts will need to develop their own approach to these issues in order to protect shareholders without exposing companies listed in the UK to unreasonable risk.

Practical tips for managing the risk of shareholder litigation

To reduce potential exposure to shareholder class actions, in-house counsel of UK listed companies (or companies preparing to list in the UK) might wish to take the following steps:

1) Implement robust and comprehensive internal procedures for the preparation of public disclosures. These should be regularly reviewed to ensure that material information is properly filtered up from each level of the company's operations. This should be an open and transparent process with effective systems of oversight and accountability at each stage.

2) Maintain detailed records of the steps taken to verify statements made in the company's disclosures. This will help to demonstrate



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the company’s belief in the accuracy of its disclosures at the time they were made, should the company face a claim from shareholders.

3) Provide directors with regular training on their responsibilities and duties in approving disclosures, and on their potential personal liability for untrue or misleading statements made by the company.

4) Directors should take an active role in challenging and scrutinising the disclosure process. They should stress-test the information they receive with the disclosure committee (if there is one) and with the heads of the relevant business units. Directors should not simply ‘rubber stamp’ disclosures.

5) The company should seek the advice of legal, accounting and financial advisers to assist with the preparation of disclosures. These advisers should be given appropriate access to information and personnel from the company to allow them to properly prepare and appraise the company’s disclosures. Directors should nevertheless independently satisfy themselves of the adequacy of the disclosures they are approving, rather than relying entirely on the company’s external advisers.

6) Existing disclosures should be kept under constant review, and consideration should be given to the need for ad hoc disclosures or a supplementary prospectus to be published if there is a material change in the company’s circumstances which may render existing disclosures untrue, misleading or incomplete. Particular care should be taken where existing disclosures relate to matters where the potential impact on the company’s prospects is likely to change over time, such as ongoing litigation or regulatory investigations.

7) The scope and adequacy of any existing directors’ and officer’s (D&O) insurance should be assessed to ensure that the company’s directors are sufficiently protected against any liability relating to their role in the disclosure process.

8) In the context of an IPO, consideration should be given to obtaining bespoke public offering of securities insurance (POSI), as directors’ liability under s90 FSMA will often not be covered by standard D&O policies.

The future?

As more of these claims progress through the English courts, and a body of precedent starts to emerge, we anticipate that the momentum behind the UK securities litigation market will continue to grow, paving the way for more shareholder class actions in the future. This could be mirrored across Europe, Asia and Australia.

As for the UK, how the courts approach the important questions of statutory interpretation in these early cases will largely determine the direction of the UK securities litigation market, and how far we continue to accelerate towards the global trend of US-style shareholder actions.

Clifford Chance and securities litigation

Clifford Chance is at the forefront of this developing market and we are uniquely placed to guide issuers through the evolving landscape of UK securities litigation. As well as extensive experience in the UK, our US litigation practice has over 30 years of experience of US class actions – and so we are able to leverage that expertise in order to anticipate the direction of travel in this expanding global industry. ■