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RISE IN UK STOCK DROP CLAIMS NOT CHECKED BY TESCO

In recent years, there has been a marked increase in "stock drop" claims brought against UK-listed companies, including claims against RBS and Tesco. None of these claims have yet reached judgment, and so the ambiguities in the legislation remain largely unresolved.

The rapid growth of the third party litigation market, combined with uncertainty in this area of the law and the possibility of substantial recoveries, means that UK-listed companies are targets for large shareholder claims.

A recent attempt by Tesco to strike out claims against it on the basis that the claimants did not have sufficient standing to bring the claim has failed.

Key issues

- "Stock drop" claims have become a target for litigation funders.
- The relevant legislation is untested in the English courts, which gives rise to uncertainty.
- A recent attempt by Tesco to curtail such claims has failed.
- How the courts approach the first cases, particularly in relation to reliance, will shape the law in this area for years to come.
- Clifford Chance is at the forefront of this developing market and are excellently placed to guide litigants through the evolving landscape of UK securities litigation.

WHAT ARE "STOCK DROP" CLAIMS?

When a company's share price falls sharply in reaction to a corporate scandal or other misfeasance being revealed to the market, shareholders may bring a claim to recover losses suffered as a result of the drop.

The shareholder class action brought against The Royal Bank of Scotland represented a watershed moment in the development of securities litigation in the UK. Since then, we have seen more shareholder claims in the UK, with actions against Lloyds and Tesco, and many more understood to be in the pre-action phase.

WHAT ARE THE KEY ASPECTS OF THE LAW?

The principal statutory basis for these claims is found in sections 90 and 90A of the Financial Services and Markets Act 2000 ("**FSMA**").

Under s90, companies and their directors (and, perhaps, their professional advisors) can be liable to pay compensation to shareholders for any untrue or misleading statement or material omission in listing particulars or a prospectus.

Defendants to s90 claims will not be liable if they can demonstrate that they reasonably believed the statements were true or not misleading or that any matters were properly omitted.

The most notable case brought to date under s90 is the *RBS Rights Issue Litigation*, in which shareholders alleged that RBS and certain of its directors were liable for misleading information concerning RBS' financial position in RBS' 2008 rights issue prospectus.

Section 90A FSMA provides a further basis of liability where an issuer makes an untrue or misleading statement or omission in other published information, such as annual accounts.

Under s90A, claimants must prove that they acquired, continued to hold or disposed of shares in reliance on the published information and suffered loss as a consequence of the misstatement or omission and in circumstances where such reliance was reasonable. There is no cause of action against directors or advisors under s90A, although a company subject to a s90A claim can in turn bring proceedings against its directors, advisors or other third parties under other causes of action.

WHAT IS THE BASIS OF LIABILITY AND HOW ARE DAMAGES ASSESSED?

The basis of liability under s90 is negligence, whereas it is fraud under s90A. Claimants under s90A must therefore establish knowledge or recklessness on the part of the issuer or a person discharging managerial responsibilities ("**PDMRs**") (i.e. a director).

In large companies, it will not be straightforward to prove that a director had the requisite knowledge of both: (a) the relevant misstatement or omission (particularly given the number of professional advisors involved in the disclosure process); and, (b) the underlying issue within the company to which the misstatement or omission related.

The calculation of loss under s90 and s90A is highly complex. The UK Government took the view that it would not be desirable to tie the courts' hands by legislating as to how damages ought to be assessed. However, it remains unclear how the courts should approach loss in circumstances where prices of securities are subject to various market factors.

For example, it is not straightforward to assess the extent to which any share price decline has been caused by particular misstatements or omissions coming to light, or other unrelated market events. Investors will also buy, hold and sell shares at different times, which raises questions as to when loss ought to be calculated and how it ought to be assessed across the claimant group. Investments may be part of a broader trading strategy involving hedging for which claimants may need to give credit.

The continuing uncertainty in this area may encourage opportunistic claimants to bring claims on the basis of unrealistic loss assessments.

TESCO: SECTION 90A UNDER THE MICROSCOPE

The purpose of introducing a statutory issuer liability regime was to enhance shareholder protection in this area, yet no claims under s90 and s90A have yet reached judgment, and some uncertainty remains.

The s90A claim brought by shareholders against Tesco, which relates to alleged profit overstatements in Tesco's annual accounts, is due to go to trial next year. Tesco entered into a deferred prosecution agreement with the Serious Fraud Office in 2017, although three former Tesco executives were subsequently acquitted of fraud and false accounting.

Last month, Tesco brought a strike-out application alleging that the claimants did not have standing to bring their claims.

- Tesco said that the claimants did not hold legal title to their shares, which was instead held by nominees through CREST, the electronic system for the transfer of shares.
- The claimants' position was that their beneficial interest in the shares was sufficient for them to bring the claim and, if successful, Tesco's application would frustrate the purpose of the legislation.

Mr Justice Hildyard refused Tesco's application, finding that the wording of s90A is sufficiently broad to mean that a claimant with just the beneficial interest in a security had, nevertheless, sufficient standing to bring a claim.

He considered that there is "*semantically no real doubt that the investor* [who holds their shares through CREST] *has an "interest" in the securities; and similarly, there is legally no doubt that such interest is equitable/proprietary…* [which] *suffices to qualify as "any interest in securities" for the purpose of Schedule 10A*".

However, Hildyard J did recognise that such claims must be limited only to investors with proprietary interests in the security, not simply economic interests (i.e. contractual or personal rights), so as not to expose issuers to liability to an indeterminate class of claimants, whilst also ensuring that s90A provides an effective mechanism of investor protection.

He also rejected the second limb of Tesco's argument, that none of the claimants had "*acquired*" or "*disposed*" of an interest in the securities because the transferring of shares held through CREST only constituted the transfer of legal title, with the claimant's beneficial interest being created or extinguished, rather than "*acquired*" or "*disposed*". Hildyard J considered that the language used in the statute was capable of extending to such situations, and that there was "*every reason to give the expressions such meaning here, to ensure the achievement, rather than the negation, of the statutory purpose*".

Given the importance of the point, it is likely to be appealed by Tesco, who have been granted an extension to the window for applying for permission to appeal until 5 November 2019.

RELIANCE AND THE PRESUMPTION OF INDUCEMENT

A further key area of uncertainty is the requirement under s90A that claimants must have relied on the published information. But how is reliance to be established and who has the burden of proof?

On the one hand, the statute is clear that claimants need to have acquired, continued to hold or disposed of shares in reliance on published information. In March 2010, HM Treasury gave the example of an investor reading the relevant information and, as a result, instructing his broker to cancel a sell order and instead retain a holding of the company's securities. However, a requirement to prove "*active*" reliance in this way may be a too restrictive an interpretation.

In the Tesco litigation, the claimants have argued that the "*presumption of inducement*" principle should be imported from the English law tort of deceit. This would have the effect of reversing the burden of proof onto Tesco to demonstrate that any misstatement or omission did not play a "*real and*

substantial part" in the claimant's decision to buy, hold or sell their securities, rather than the claimant bearing the burden of proving it did.

However, this interpretation of reliance would appear to be inconsistent with the wording of the statute, which could have expressly incorporated a presumption of inducement, but did not.

In the *Tesco* case, the claimants were ordered to provide particulars of their respective reliance. If this approach is maintained by the courts, and claimants cannot successfully argue that there is a presumption of inducement, it will remain a significant legal, evidential and practical challenge for claimants to prove on an individual basis that they relied on specific statements made by a company.

WHAT CAN WE LEARN FROM THE US AND AUSTRALIA?

In the US, where there is an established body of jurisprudence in relation to "*stock drop*" claims that has emerged over several decades, courts have adopted a "*fraud on the market*" approach to reliance at the crucial class certification stage.

US courts assume that the issuer's securities are traded in an efficient market, which means that all available information is incorporated quickly into the share price. When an investor buys a share in an efficient market, they are relying on the price, and therefore all information put into the market by the issuer, including any material misstatements or omissions.

It is open to defendant companies to argue that their securities are not traded in efficient markets and/or that the claimants relied on information other than the misstatement or omission, but this may be difficult to overcome.

Although the "*fraud on the market*" approach to reliance is alien to English law, it has been adopted in other common law jurisdictions (for example, in Australia; see *HIH Insurance Ltd (in Liquidation)* (2016) 335 ALR 220), although it is notable that the equivalent Australian legislation does not include an express reliance requirement in its drafting.

In the *Tesco* litigation, the claimants initially ran a "*fraud on the market*" argument, which Hildyard J described as "*intriguing*", but abandoned it, instead arguing that: (a) they would demonstrate that they *actually* relied on Tesco's published accounts (including by way of witness evidence); and (b) the presumption of inducement places the burden of proof on Tesco to disprove that reliance.

COMMERCIAL DYNAMICS IN SHAREHOLDER CLAIMS

The growth of the litigation funding market in the UK has been widely reported over recent years. Shareholder claims are particularly attractive to third party funders given the amounts that can be at stake in such claims. Even relatively small share price drops can lead to significant losses when large numbers of claimants are brought together.

From the claimants' perspective, a third party funder will bear the risk of the claim failing whilst also enabling them to share in the upside if the claim succeeds. Equally, the risk of being liable for a defendant's costs in the event that the claim is unsuccessful can be neutralised by insurance.

The use of group litigation orders can further reduce the administrative time and cost of bringing claims of this size.

CLIFFORD CHANCE AND SECURITIES LITIGATION

Clifford Chance is at the forefront of this developing market and we are uniquely placed to guide issuers and others 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 area of the law.

CONTACTS

Ian Moulding
Partner

T +44 20 7006 8625
E ian.moulding@cliffordchance.com

Chris Yates
Partner

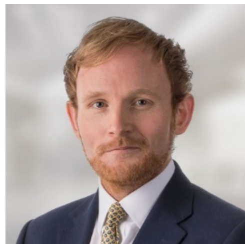
T +44 20 7006 2453
E chris.yates@cliffordchance.com

Stephanie Huts
Senior Associate

T +44 20 7006 6382
E stephanie.huts@cliffordchance.com

Jason Epstein
Senior Associate

T +44 20 7006 3996
E jason.epstein@cliffordchance.com



Guy Burkitt
Senior Associate

T +44 20 7006 1872
E guy.burkitt@cliffordchance.com

Ryan Byrne
Associate

T +44 20 7006 2142
E ryan.byrne@cliffordchance.com

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www.cliffordchance.com

Clifford Chance, 10 Upper Bank Street, London, E14 5JJ

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