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Section 11 Damages and Stock-For-Stock Acquisitions: Legal and Economic Considerations

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Damages under Section 11 of the Securities Act of 1933 are calculated using a statutory formula. In many cases, the inputs to that formula are simple to determine and its application is straightforward. That is not always the case, however, when the offering at issue is part of a stock-for-stock acquisition.

In this article, we discuss two issues that can arise in trying to operationalize Section 11's damages formula in the context of a stock-for-stock acquisition. The first is how to determine the amount paid and offering price for securities issued in those acquisitions, which is the starting point for the Section 11 damages calculation. The second is how to calculate Section 11 damages where target company shareholders receive more than one type of security as payment in the acquisition. Both of these questions implicate economic principles, which are particularly informative given the scant case law addressing these subjects. We will close by discussing how these damages issues can impact litigation strategy at multiple phases of the case.

Statutory Background

Section 11 of the Securities Act of 1933, 15 U.S.C. § 77k, allows investors to hold issuers, officers, underwriters, outside auditors, and certain other specified individuals liable for damages caused by false or misleading statements in a registration statement. Unlike Section 10(b) of the Securities Exchange Act of 1934 and other liability provisions under the securities laws, Section 11 provides a formula for calculating damages. Courts have emphasized that this formula is the only appropriate method for calculating damages under Section 11 and have rejected attempts to employ alternative measures. See, e.g., *McMahan & Co. v. Wherehouse Entm't, Inc.*, 65 F.3d 1044, 1048 (2d Cir. 1995) (rejecting attempt to seek "benefit-of-the-bargain damages" noting that "[t]he plain language of section 11(e) prescribes the method of calculating damages … and the court must apply that method in every case").

Subject to a showing by defendants that certain price declines were caused by factors other than the alleged misstatements at issue, often referred to as a negative loss causation defense, a Section 11 claimant can recover:

> … damages as shall represent the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and (1) the value thereof as of the time such suit was brought, or (2) the price at which such security shall have been disposed of in the market before suit, or (3) the price at which such security shall have been disposed of after suit but before judgment if such damages shall be less than the damages representing the difference between the amount paid for the security (not exceeding the price at which the security was offered to the public) and the value thereof as of the time such suit was brought …

The starting point for the calculation is the "amount paid" capped by "the price at which the security was offered to the public," which we will refer to as the "offering price." The next input depends on if and when the security was sold, with the entire calculation illustrated as follows:

<table>
<tr><td rowspan="5"><u>Amount Paid</u>
(capped by
<u>Offering Price</u>)</td><td rowspan="5"><u>minus</u></td><td>Security Sold Before Suit</td><td>→</td><td><u>Sale Price</u></td></tr>
<tr><td></td><td>or</td><td></td></tr>
<tr><td>Security Still Held</td><td>→</td><td><u>Lawsuit Date Value</u></td></tr>
<tr><td></td><td>or</td><td></td></tr>
<tr><td>Security Sold After Suit</td><td>→</td><td>Greater of <u>Sale Price</u> or
<u>Lawsuit Date Value</u></td></tr>
</table>

Both sides of this formula can be complicated in stock-for-stock acquisitions.

Offering Price and Amount Paid

The starting point for the Section 11 damages calculation is the amount paid for the security, capped by its offering price. In many offerings, these variables are easy to determine. Take the example of an initial public offering, or IPO. An issuer sets the price for newly issued shares of its common stock at $10 per share. Investors who participate in the offering pay $10 for each share. For Section 11 purposes, the offering price is $10. The amount paid by investors who participated directly in the offering likewise is $10. And the amount paid by investors who purchased shares in the aftermarket would be the price at which they bought their shares, but no more than the $10 offering price for purposes of calculating Section 11 damages.

Stock-for-stock acquisitions, by contrast, don't fit so neatly. Unlike in the IPO scenario described above, target company shareholders don't pay a set price in cash in exchange for newly issued securities. Instead, they exchange their shares in the target company for securities issued by the acquiring company. The acquisition agreement sets the terms, including the ratio of shares in the acquirer issued in exchange for shares in the target, i.e., the exchange ratio.

There are two broad types of exchange ratios: fixed and floating. A fixed ratio holds constant the number of securities the acquirer will issue and convey to the target company shareholders—e.g., one target company share for two shares of acquirer stock. Flexible exchange ratios allow the number of shares the acquirer issues and conveys to fluctuate with market prices, often with a goal of holding constant the total value conveyed—e.g., one target company share for $10 of acquirer stock. The acquisition consideration may be complicated by inclusion of cash, multiple securities, and combinations of fixed and floating exchange ratio terms.

For purposes of illustration, we'll use a hypothetical Section 11 claim arising from a stock-for-stock acquisition in which each target company share was exchanged for one share of acquirer common stock and one share of acquirer preferred stock. The market prices of the securities involved—all publicly traded, for simplicity's sake—were as follows:

Event	**Target Common**	**Acquirer Common**	**Acquirer Preferred**	**Total Merger Consideration (Common + Preferred)**
Prior to Acquisition Close				
Merger Agreement	$25	$16	$11.50	$27.50
Final Prospectus	$27	$14	$14	$28
Shareholder Approval	$28.50	$15	$14	$29
Immediately Before Closing	$31	$16	$15	$31
Post Corrective Disclosure (prior to Lawsuit Filing)				
Securities Sold	N/A	$15	$17	$32

In such a stock-for-stock acquisition, what are the "amount paid" by target company shareholders and the "offering price" for the securities of the acquirer for purposes of calculating Section 11 damages?

In determining both the amount paid and offering price, an initial question is whether to look to the target company securities being given as payment in the acquisition, or the securities being given as consideration by the acquirer in the transaction. Once you have made that determination, the question becomes whether you look to the price of the securities at issue or some measure of their intrinsic value.

Both economically and legally, the price of target company shares—i.e., the first column in the hypothetical above—makes the most sense. The "price" target company shareholders pay is to relinquish their shares in exchange for shares in the acquiring company. Put differently, what was paid by the target company shareholder, the equivalent of the $10 in the IPO discussed above, was the target company share. And the statute itself dictates that it is the price—rather than any notion of intrinsic value—that should be used to determine the dollar amount used in the formula itself. Indeed, courts have been careful to distinguish the terms "price" and "amount paid" from the term "value" in construing Section 11(e). See, e.g., *McMahan*, 65 F.3d at 1048-49 (discussing "Congress' use of the term 'value,' as distinguished from the terms 'amount paid' and 'price'").

The few legal authorities to have expressly addressed this issue are in accord. Specifically, they recognize that the starting point for calculating Section 11 damages arising from a stock-for-stock acquisition should be based on the price of target company shares. See, e.g., *Freedman v. Value Health, Inc.*, 190 F.R.D. 33, 35 (D. Conn. 1999) (holding that in "the damages calculus under § 11" a plaintiff's "[r]ecovery is based on the market price of the shares used as currency in the merger"); 5 Disclosure & Remedies Under the Sec. Laws § 3:88 ("in a merger, the 'amount paid' by the stockholders of the disappearing merger partner is the market price (not the intrinsic value) of the disappearing merger partner's shares").

Turning to the mechanics of the calculation, when determining the amount paid it is often straightforward to look to the market price of the target company shares immediately prior to their exchange for acquiring company securities ($31 in our hypothetical above), assuming the target company shares are publicly traded. In an efficient market, investors engaging in merger arbitrage ensure that the market prices for the target company and acquiring company shares will converge, particularly after it becomes clear that regulatory and shareholder approvals will allow the acquisition to proceed as planned.

Thus, at the moment of exchange the amount paid by target company shareholders typically will match the value of consideration that will be received, including acquiring company shares, cash, and any other securities—as reflected in the above hypothetical. In practice, the target company shares may cease trading prior to the exchange and so the last observed market price of target company shares may differ slightly from the value of consideration conveyed by the acquirer.

Determining the amount paid for a private company is complicated by the absence of a continuous market price for the private company shares. However, the absence of continuous market prices does not mean there are no prices. Alternatives to public secondary market prices may be available. For example, the company itself may periodically sell and repurchase shares to/from its investors, or shares may trade in private markets. Merger agreements may, however, place restrictions on issuance or repurchase of target company shares while the transaction is pending, potentially complicating determination of a price for target company shares.

As noted, under the Section 11 damages formula, the "amount paid" is capped by the "offering price." Determining the offering price is more complicated than determining the amount paid because it requires determining not only what to measure, as discussed above, but also when to measure it.

There are several deal process milestones that might be considered: the signing of the merger agreement between the acquirer and target companies, the issuance of a final prospectus to target company shareholders for approval, the shareholder approval date, or the transaction closing date. As illustrated in the hypothetical above, the prices of both target and acquirer securities can vary over the course of a deal, not only in absolute terms (as all securities prices can fluctuate) but also relative to each other in ways that reflect the impact of the merger itself.

In an acquisition, the acquirer typically offers a premium above the price of the target company shares in order to induce the target company shareholders to agree to the sale. In our hypothetical, that premium is represented by the $2.50

difference between the price of the target company common stock ($25) and the total value of the consideration ($27.50) immediately prior to the acquisition being announced—a 10% premium. Immediately following the announcement, the prices of both target and acquirer begin to reflect the value of the combined company. As a result, the price of target company stock and acquirer securities used as merger consideration converge, subject to investor expectations of the likelihood and timing of deal completion.

Which of these milestones, then, is the appropriate one for measuring the offering price for Section 11 purposes? As noted above, the “price” the target company shareholders pay is to relinquish their shares. It follows that the offering price should represent the price of what target company shareholders are giving up: an equity interest in a standalone company. In a stock-for-stock transaction, the acquisition agreement between acquirer and target specifies the exchange of shares in a standalone company for shares in the combined company. The shareholder vote providing approval for the transaction decides whether the target remains standalone or is acquired.

To the extent the offering price is based on the price of the target company as a standalone company, only the date the acquisition agreement is signed allows measurement of the target company share price unaffected by the impending transaction. Once the deal is announced, as noted above, the market prices of the target company's shares no longer reflect the standalone value of the target, but instead represent the market's expectation of the value of the combined company shares. In situations where deals are renegotiated, are subject to a public bidding and negotiation process, or where rumors and leaks alert investors to a pending transaction, it may be necessary to identify earlier dates on which the market price of the target company's shares represents standalone value (i.e., is unaffected by expectations of the agreement itself).

Because most acquisitions are made at a premium above the standalone value of the target company shares, an “offering price” cap on the amount paid for Section 11 damages based on the price of the target company as of the acquisition agreement date will tend to reduce Section 11 damages and/or reduce the amount of losses that defendants need to rebut through negative loss causation defenses.

It also bears mentioning that parties to M&A transactions often publish “deal value” estimates in their communications to investors. One should not assume such deal values constitute a proper measure of offering price as they may be premised on particular assumptions as to how deal value is calculated, in addition to being at odds with the distinction courts have made between “price” and intrinsic “value” discussed above. Likewise, in filing its registration statement for new securities to be issued, the acquiring company may declare a value estimate for the target company shares that may be premised on certain assumptions that might not correspond to a reliable measure of “offering price.”

Bundling

A second issue arises when, as in our hypothetical above, target company shareholders in a stock-for-stock acquisition receive more than one type of security as merger consideration. Should damages be calculated separately for each security, which would result in distinct damage amounts for both common and preferred shares, or calculated for the bundle of common stock and preferred stock as a whole?

The issue is important where the investor may have disposed of one security received at a gain while disposing of the other security at a loss. Unbundling the claims would allow an investor to claim losses under Section 11 without any offset for gains that are otherwise subject to the same Section 11 claim. In our hypothetical above, the amount paid by the investor ($31, ignoring the offering price limitation) is less than the amount received after post-corrective-disclosure sale ($32 combined), but on an unbundled basis the investor lost $1 on the common stock ($16 at time of exchange versus $15 sale price) and gained $2 on the preferred stock ($15 at time of exchange versus $17 sale price).

From an economic perspective, bundling makes sense. The economic transaction giving rise to a Section 11 claim is the exchange of a target company share for a bundle of consideration that includes securities issued pursuant to an allegedly misleading registration statement. Such registration statements typically cover all registered securities to be issued in connection with the acquisition. In order to measure an investor's gain or loss on the acquisition transaction, it would make sense then to measure their gains or losses across the entire bundle of consideration received, including all securities covered by the relevant registration statement.

Bundling also works hand in glove with the conclusion above that the offering price and amount paid should be based on the price of target company shares. Section 11 damages would be calculated by taking the target company share price and subtracting from it the relevant sales prices of the entire bundle of securities received in exchange for that share. Let's assume that the Section 11 offering price in our above hypothetical is $25 (price immediately before the merger is announced) and the amount paid was $31 (last observable price before closing). Because the offering price operates as a cap, damages would be calculated taking $25 and subtracting the sum of the sale prices of each security, i.e., $15 and $17—the result being no damages in this scenario.

But if you were to attempt to do this calculation on an unbundled basis, i.e., separately for common and preferred stock, how would the amount paid and offering price limitation for each security be calculated in a principled fashion? In our hypothetical, the offering price of $25, based on the price of target company shares as of the merger announcement, is $2.50 less than the combined value of the acquirer common stock and preferred stock at the time. It is arbitrary how to assign that $2.50 difference. If one allocates that $2.50 difference entirely to the acquirer's common stock, then the investor will have no Section 11 damage claim on an unbundled basis: the investor will have sold common stock at $15 compared to a $13.50 offering price ($16–$2.50) and sold preferred stock at $17 compared to an $11.50 offering price.

On the other hand, if the $2.50 is allocated entirely to the preferred stock, on an unbundled basis the investor would have Section 11 damages for the common stock and none for the preferred: common stock sold at $15 compared to $16 offering price, preferred stock sold at $17 compared to $9 offering price ($11.50–$2.50). This hypothetical illustrates that the allocation of amount paid and/or offering price necessary to calculate Section 11 claims on an unbundled basis can arbitrarily shift gains or losses between the various securities the investors received in ways that can increase or decrease the measured damages. Measuring damages on a bundled basis avoids the need to make any such allocation assumptions.

Although courts have had little occasion to address Section 11 damages where a bundle of consideration was offered in a merger exchange, *Feit v. Leasco Data Processing Equipment Corp.*, 332 F. Supp. 544 (E.D.N.Y. 1971), takes this approach. The class plaintiffs in *Feit* brought Section 11 claims based on a merger exchange offering in which participants received a "package" of preferred shares and warrants of the acquiring company in exchange for their target company common stock. In determining whether the plaintiffs suffered damages under Section 11(e), the court considered the value realized from both elements of the "package"—that is, both the preferred shares and the warrants—as a bundle rather than separately.

Litigation Strategy

Section 11 cases seldom result in a damage award. Indeed, one commentator has noted that "less than a dozen Section 11(e) damage cases have reached judicial resolution." Michael J. Kaufman, Securities Litigation: Damages § 6:30 (Nov. 2018 Update). And we are not aware of any Section 11 case that has been tried to verdict since the enactment of the Private Securities Litigation Reform Act of 1995. Nonetheless, when facing Section 11 claims based on a stock-for-stock merger, the damages issues discussed above can impact multiple aspects of a litigation.

As an initial matter, it is necessary to consider these issues in order to fully assess the potential recovery or risk arising from a Section 11 claim predicated on a stock-for-stock merger. Because there is little guidance from courts on how to calculate Section 11 damages in this context, both plaintiffs and defendants have significant latitude to craft damages theories to benefit their clients. The result can be a wide range of possible damages figures, the full breadth of which should be considered by the parties in assessing resource allocation, litigation risk, and settlement positions.

In the litigation itself, parties can seek to obtain favorable rulings on discrete damages issues both to improve settlement leverage and even eliminate certain plaintiffs and claims altogether. The difference in total damages can vary significantly with a court decision endorsing a particular offering price or adopting a bundled approach to calculating damages. In certain instances, a plaintiff may have no damages at all and thus lack standing to bring a claim.

Courts have both dismissed Section 11 claims and denied class certification where a plaintiff lacks recoverable damages under Section 11(e). See, e.g., *In re Washington Mut., Inc. Sec., Derivative & ERISA Litig.*, 2010 BL 245820, at *13-14 (W.D. Wash. Oct. 12, 2010) (dismissing claims of proposed class representative who lacked damages under Section 11(e) and denying class certification on related Section 11 claim); *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp.2d 281, 351 (S.D.N.Y. 2003) (dismissing Section 11 claims by plaintiffs who "s[old] a security above its offering price" and thus had "no cognizable damages under Section 11 of the Securities Act").

Procedurally, rulings on Section 11 damages issues can be obtained at various points in a litigation. Courts routinely rule on Section 11 damages issues in connection with dispositive motions and at class certification. See, e.g., *In re Initial Pub. Offering Sec. Litig.*, 241 F. Supp.2d 351 (motion to dismiss); *Freedman*, 190 F.R.D. at 34-35 (class certification). *Daubert* motions can also provide a useful procedural vehicle, as courts recognize that expert opinions based on incorrect legal assumptions fail to "help the trier of fact to understand the evidence or to determine a fact in issue." Fed. R. Evid. 702; see, e.g., *Fed. Hous. Fin. Agency v. Nomura Holding Am., Inc.*, 2015 BL 39374, at *3 (S.D.N.Y. Feb. 16, 2015) (excluding expert testimony because the underlying "interpretation of [the damages provision of Section 12 of the Securities Act] is incorrect as a matter of law").

With respect to each of these options, it can be helpful to work with a loss causation and damages expert early in the process to start developing a theory of damages and litigating relevant issues when the opportunity arises.