

### Federal Court Rejects Securities Fraud Claims Based on Understated Loss Reserves

A recent ruling by the U.S. District Court for the Southern District of New York will strengthen the defense of issuers who find themselves sued for securities fraud based on understated loss reserves. The decision by Judge Robert P. Patterson, Jr. in class action lawsuits filed against Quanta Capital Holdings Ltd. continues the trend of pro-issuer securities law rulings since the Supreme Court's landmark 2007 decision in *Tellabs v. Makor*.

Quanta was a Bermuda-based specialty insurance company that was required to record reserves for property damage claims arising from Hurricane Katrina. Hurricane losses typically are subject to a substantial reporting lag, but for accounting purposes the losses are considered "incurred" even before they are reported. Quanta accordingly recorded reserves for Katrina-related losses based on predictions generated by actuarial models. Months later, after actual loss data began to trickle in, Quanta revised its loss estimates (and its reserves) upward substantially. Quanta's common stock price plummeted 40 percent after the reserve increase was announced, and two class actions followed, *Zirkin v. Quanta Capital Holdings Ltd.* (2009 WL 185940 (S.D.N.Y.)) and *Coronel v. Quanta Capital Holdings Ltd.* (2009 WL 174656 (S.D.N.Y.))

As often happens when an issuer suffers a significant stock price setback after disclosing a reserve increase, the plaintiffs alleged that Quanta should have known and disclosed the bad news about the severity of its Katrina-related exposure sooner. The cases included claims under Sections 11 and 12(a)(2) of the Securities Act, alleging false statements in a December 2005 stock offering, and claims under Section 10(b) of the Exchange Act, alleging that Quanta's SEC filings and public statements were fraudulent because of the understated reserves.

Judge Patterson's opinion dismissed all claims prior to any discovery. The Securities Act claims were dismissed because plaintiffs failed to plead facts supporting an inference that Quanta's initial reserve estimates were false *at the time they were issued*. The Court rejected the plaintiffs' "retrospective analysis of awareness," which inferred that earlier loss estimates must have been false merely because later estimates of the same losses were higher.

The Court also dismissed the plaintiffs' Section 10(b) fraud claims for failure to allege facts suggesting that the defendants had a motive to commit fraud, or facts that would constitute "strong circumstantial evidence" of conscious misbehavior or recklessness. The plaintiffs asserted that Quanta executives had a motive to conceal losses because of concerns about a potential credit rating downgrade. Judge Patterson deemed this insufficient as a matter of law because the desire to preserve a credit rating is a generic motive possessed by all corporate issuers. The Court also rejected the allegation that the dramatic increase in Quanta's hurricane loss estimate was "strong circumstantial evidence" that the original estimate was the product of an intent to mislead, calling this an improper attempt to infer "fraud by hindsight."

Allegations of GAAP violations based on misstated reserves appear with great frequency in securities fraud class action complaints. Judge Patterson's decision is welcome news for issuers trying to navigate the hazardous waters created by the financial crisis, global economic uncertainty, and the ever-increasing complexity of accounting rules.

*Quanta has been represented in these cases by Andrew Ruffino and Michael Schlanger of Covington & Burling LLP. Covington's Securities Litigation and Securities Enforcement practice group represents issuers, underwriters and corporate officers and directors in securities fraud class actions as well as in SEC investigations and enforcement proceedings. The 22 partners and counsel in this group are based in Covington's New York, Washington, and San Francisco offices.*

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