Gross Orad Schlimoff & Co.

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Securities Class Action - Method of Calculating Damage

Until recently, all securities class actions in Israel were settled (or withdrawn) without a full trial taking place. The Shemesh vs. Reichart case is the first securities class action that was tried and ended with a judgment being handed down. Moreover, an appeal was filed to the court of highest instance - the Supreme Court of Israel - whose decisions are binding on all lower courts. It is therefore not surprising that several issues of precedential nature were determined in this case.

The Reichart Facts and Ruling - in a Nutshell:

The Reichart Company initiated an initial public offering by way of a prospectus. Many material matters in the prospectus were false and misleading. Eventually, the fraud was discovered causing the value of the company's shares traded on the stock exchange to drop sharply, and subsequently a liquidator was appointed.

One of the major issues considered by the Supreme Court was the correct method for calculating the loss to the class members (public shareholders of the company). The Supreme Court ruled that, in principle, the calculation of the loss of the class members should be carried out on an individual basis rather than by a gross estimate of the loss to the entire class.

Conflicting views and Considerations

Plaintiff asserted that the loss of each class member should be determined by the balance of the purchase price of the securities less the stock market price subsequent to the fraud's discovery (following the sharp drop in value). Defendants counter argued that such a method ignores market fluctuations that occurred irrespective of the fraud which influenced the price.

The Supreme Court reviewed several different possible methods for calculating the loss, as follows:

The ***out of pocket*** method: The balance between the actual purchase price and the true value of the shares had no misrepresentation occurred. The date of purchase is therefore the relevant date for effecting the entire calculation. This method prevents compensation for loss of value, unrelated to the fraud, that may have occurred after the purchase date.

This method is based on the premise that it is the investor - purchaser of the securities who assumes the risk of market fluctuations which are unrelated to the fraud.

The rescissionary damages method: Compensation for the full difference between the purchase price and the market price subsequent to discovery of the misrepresentation, including loss related to market fluctuations.

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The ***modified out of pocket*** method: This is similar to the rescissionary damages method. However, any loss caused by market fluctuation is carved out. In other words, from the result of the rescissionary damages method of calculation, this modified method deducts the overall rate of market fluctuations in the period between purchase and discovery of the fraud.

The Supreme Court in the Reichart Case reviewed the nature and characteristics of a securities loss and reached the conclusion that such loss is, in essence, tortuous. Therefore, the Supreme Court found that the most appropriate method for calculating a securities loss as a result of misrepresentation was the ***out of pocket*** method, which purports to compensate precisely for the additional inflated element on the price that was a direct result of the fraudulent misrepresentation. The ***rescissionary damages*** method was deemed inappropriate as it is contractual by nature. Therefore, it would be justified regarding those who purchased directly from the company at the IPO, but would be irrelevant regarding purchasers on the secondary market, who have no contractual relationship with the company.

Calculation of the loss according to the out of pocket method, that was preferred by the Court, is far from simple as it involves determining the hypothetical value of the share at the date of purchase, had the investors been in possession of the full and accurate information.
Note that this hypothetic determination must be determined for each individual investor. The imaginary value is then compared with the price actually paid for the shares on all the aforesaid dates and compensation calculated accordingly.

The Supreme Court thus set out the principles for calculating the loss according to the out of pocket method and remanded the case back to the District Court to perform the calculation. Nonetheless, although clearly preferring the out of pocket method, surprisingly the District Court was authorized by the Supreme Court to consider adaptation of the calculation. In its instructions the Supreme Court stated that implementing the out of pocket method partially on an approximation basis, such as the "modified out of pocket" method, could be considered if necessary.

Significant achievement for Jewelers Block Insurers

In C.C 2427/02 ***Gertler v. Certain Lloyd's Underwriters*** (The District Court in Tel Aviv), the court ruled in favor of Underwriters on several precedential and fundamental issues regarding entrustment of diamonds to a third party for sale purposes. Underwriters were represented by the law firm of Gross Orad Schlimoff & Co.

The facts

The Assured, a diamond dealer, worked for several years with a diamond dealing broker. In the course of their business, the Assured entrusted diamonds to the broker against memo notes. In addition, part of the diamonds was handed over to the broker against post dated cheques.

At some stage, the broker advised the Assured that he was robbed in Hong Kong and that the diamonds in his possession were stolen.

Allegedly, only following the robbery did the Assured discover that the broker had conducted misleading and fraudulent acts towards the Assured ***at the Assured's office in Israel***. According to the Assured, he agreed to hand over the diamonds to the broker only due to the broker's misrepresentations that the diamonds previously handed over to him had been sold and are no longer in his possession. In fact, the Assured was fraudulently led to believe that the value of diamonds in the brokers' possession is significantly lower than it later transpired. >

The District Court addressed the following issues:

- Is the Assured entitled to insurance benefits when he entrusted diamonds for sale purposes to a broker and the latter did not return the diamonds nor pay the Assured their consideration?

- Is there a distinction, for indemnification purposes, between diamonds which were handed over by the Assured to a third party on memo and diamonds which were handed over against post dated cheques?

- Territorial limits of the policy were restricted to Israel only. Although the Assured entrusted the diamonds to the broker in Israel, within the territorial limits of the policy, the entrustee took the diamonds with him to Hong-Kong, outside policy territorial limits, and was allegedly robbed there. The court had to determine whether the Assured, who himself did not breach the policy territorial limits, is entitled to cover under the policy.

  According to the Assured, the broker defrauded him at the time he received the diamonds from him and this was the reason why the Assured was willing to give him diamonds in a very high volume. Should such fraud or misrepresentation by a third party be considered theft, and, as such, be covered by a JB policy?

- Does the policy infidelity exclusion apply to a broker of the Assured? Does the inclusion of the broker in the policy as an additional insured (by using the words and/or) preclude Underwriters from applying the infidelity exclusion?

Following extensive and lengthy litigation the Court accepted all of Underwriters' contentions and dismissed the Claim.

The Court ruled as follows:

In order to determine the above mentioned issues, the court examined what the Assured›s point of view was at the time he delivered the diamonds to the broker.

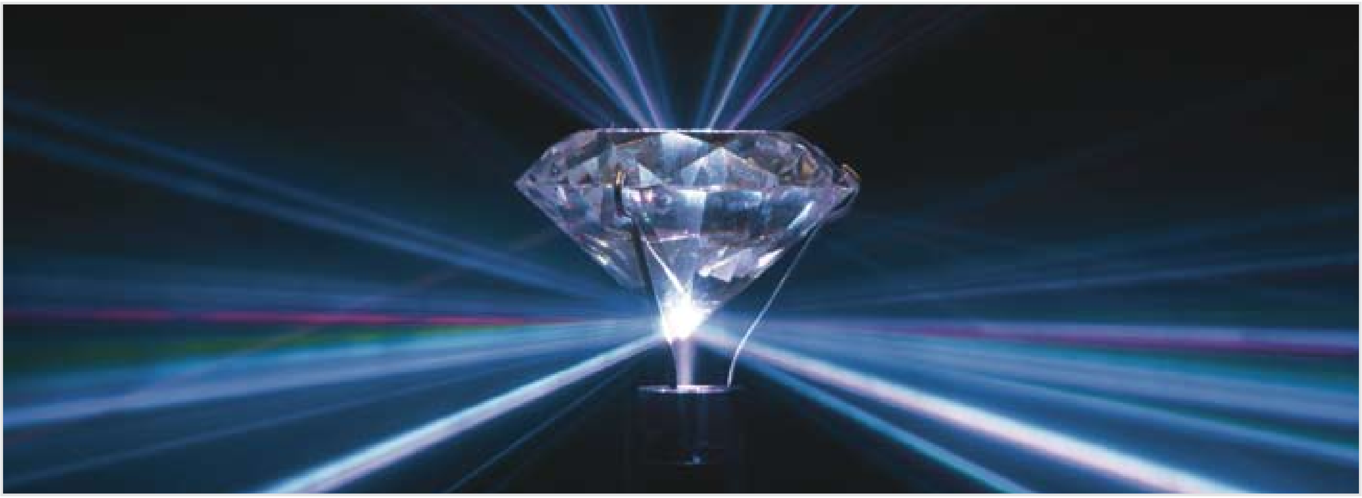
As a general rule, under an All Risks policy the Assured must only prove that he delivered the diamonds to a third party and that no sale occurred. If the diamonds were entrusted to a third party who did not return them nor their consideration, the insured is entitled to insurance benefits, unless insurers can prove that the loss is excluded from cover pursuant to a specific exclusion.

However, ***in this case***, the court determined that the loss occurred as a result of the robbery in Hong Kong, outside the policy territorial limits. Therefore, the loss is not covered under the policy. The court dismissed the allegation that since the broker allegedly defrauded the Assured at the time he received the diamonds from the Assured, in Israel, then the insured event occurred at the place and at the time the diamonds were handed over to the broker. The application of the infidelity exclusion depends upon its exact wording. The infidelity exclusion usually excludes infidelity of a broker. In this case, the fact that the broker was named as an additional insured does not mean that Underwriters were willing to insure any loss or damage as a result of infidelity of the broker who was named as an insured.

It should also be noted that this is one of the rare cases where the court not only dismissed the insured›s allegation that Underwriters› behavior was not in good faith, but rather determined that Underwriters acted in good faith and in accordance with their rights pursuant to the policy. In this respect the court determined that:

"It is the Assured who should be criticized for his behavior by not hesitating to discredit the defendants› reputation and by raising severe allegations against them, with no basis at all."

The Assured filed an appeal to the Supreme Court, which is yet to be decided. We believe that the District Court›s Judgment is well founded and includes comprehensive and logical analysis of the evidence, and is therefore most likely to be affirmed by the appellant court.



Limitation Argument is Available to an Insurer despite receipt of Notice of the Claim before it Expired

A recent judgment handed down by the Tel-Aviv Magistrate's Court clarified the rule relating to the period of limitation in personal injury insurance cases (C.C. 17203-05 ***Rodavsky v. Clal Insurance Co.***). The judgment also referred to the question in which circumstances will the insurer's behavior prevent it from alleging that the limitation period had elapsed.

The facts were as follows: The Plaintiff was injured in 2001, when he was 17 years of age, during a basketball game. In 2004 he was diagnosed as having a permanent partial disability. He filed his action against his personal injury insurer on 22 February, 2005, three years and six days after having reached maturity.

Pursuant to the Israeli Limitation Law - 1958, if a minor is injured, the limitation period for filing suit against the wrongdoer only commences from the date the minor reaches maturity. Section 31 of the Insurance Contract Law - 1981 provides that the period of prescription in an action for insurance benefits is three years from the date of occurrence of the insured event.

The Magistrate's Court relied on a previous Supreme Court precedent in C.A. 1806/5 ***Harel Insurance Company V. the Estate of Amitai***, which determined that the limitation period regarding disability claims caused by an accident, starts on the day of the accident itself, rather than on the date the extent of the injury crystallizes. Since the assured filed his claim 6 days following the three year period which commences on the day he reached maturity, the Magistrate's Court decided that the claim was time barred.

An important issue determined by the court was the assured's argument that the insurer should be estopped from raising a limitation defense. The assured based this argument on the insurer's alleged tacit waiver of this defense by acknowledging in writing that the assured's claim notification had been received and inviting him to fill out an appropriate claim form.

The letter in which such receipt was acknowledged did not include a notation reserving the insurer's rights, including in respect of the limitation period.

The court rejected this argument and ruled that, in effect, it was the insurance broker who sent the assured this letter. Furthermore, the letter did not include any admittance regarding the assured's substantial rights, as required by the Limitation Law, in order to extend the limitation period.

The court also rejected the assured's allegation that the insurer had acted in bad faith, or had misrepresented to the assured that his claim was being appraised on its face value without any potential time limitation arguments being considered.

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