Cooley

Why Event-driven Securities Litigation Has Become a Thing – and a Lucrative One Too

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If Matt Levine has a mantra in his "Money Stuff" column on *Bloomberg*, it's this: everything is securities fraud. "You know the basic idea," he often says in his most acerbic voice,

> "A company does something bad, or something bad happens to it. Its stock price goes down, because of the bad thing. Shareholders sue: Doing the bad thing and not immediately telling shareholders about it, the shareholders say, is securities fraud. Even if the company does immediately tell shareholders about the bad thing, which is not particularly common, the shareholders might sue, claiming that the company failed to disclose the conditions and vulnerabilities that allowed the bad thing to happen. And so contributing to global warming is securities fraud, and sexual harassment by executives is securities fraud, and customer data breaches are securities fraud, and mistreating killer whales is securities fraud, and whatever else you've got. Securities fraud is a universal regulatory regime; anything bad that is done by or happens to a public company is also securities fraud, and it is often easier to punish the bad thing as securities fraud than it is to regulate it directly." (Money Stuff, 6/26/19)

(See this PubCo post.) But should everything really be securities fraud? An interesting new paper examines the phenomenon.

Much securities fraud litigation involves allegations of company conduct such as cooking the books or inflating the company's prospects—conduct that, if true, causes direct harm to shareholders. Some securities litigation, however, is based on events such as oil spills or product defects—conduct that causes direct injury primarily to a different set of constituents, but only indirect injury to shareholders. Yet, when the stock drops after the event, shareholders sometimes sue the company, contending that the company provided inadequate disclosure about the risks related to the event. This type of litigation, often referred to as "event-driven securities litigation," has become increasingly common.

Sidebar

In 2020, the U.S. Chamber Institute for Legal Reform and the Center for Capital Markets Competitiveness of the U.S. Chamber of Commerce filed a rulemaking petition asking the SEC to use its authority under the Private Securities Litigation Reform Act to take on event-driven securities litigation arising out of the COVID-19 pandemic. In particular, petitioners asked the SEC "to bar liability for statements about a company's plans or prospects for getting back to business, resuming sales or profitability, or other statements about the impacts of COVID-19, whether forward-looking or not—as long as suitable warnings were attached." Petitioners argued that securities litigation has been predicated on "wildfires, oil spills, product recalls, a plane crash, and a dam collapse." However, Petitioners considered these cases to often be of "dubious merit," filed to "extract a quick settlement." They indicated that securities class actions based on COVID-19 have already been filed, and predicted that "pandemic-related events will be seized upon as the basis for additional securities litigation."

Petitioners considered the recent increase in securities litigation to be driven in large part by the growth of event-driven claims, citing in support Professor John Coffee of Columbia Law School:

> "Once, securities class actions were largely about financial disclosures (*e.g.*, earnings, revenues, liabilities, etc.). In this world, the biggest disaster was an accounting restatement. Now, the biggest disaster may be a literal disaster: an airplane crash, a major fire, or a medical calamity that is attributed to your product…. The expectation of major losses from the disaster sends the issuer's stock price down, which in turn triggers securities litigation that essentially alleges that the issuer failed to disclose its potential vulnerability to such a disaster."

In these cases, Coffee argued, plaintiff's counsel do not spend months building a case to plead scienter with particularity; rather, these cases are filed quickly, and "that may be because 'some plaintiff's counsel are less concerned about surviving a motion to dismiss because they expect an early (and cheap) settlement.'" The characteristics of this event-driven litigation, petitioners argued, are just like the those that led Congress to pass the PSLRA. Although the "legitimacy of these lawsuits is highly suspect," the litigation creates "a large potential exposure. The defense costs are high, and few companies want to risk the reputational damage that could result from prolonging the litigation of such claims."

Is Everything Securities Fraud?, by Emily Strauss, a professor at Duke Law School, examines the prevalence and attributes of event-driven securities litigation. The author looked at approximately 400 securities class actions against public companies during the period 2010 to 2015. The author found that about 16.5% of securities class actions "arise from misconduct where the most direct victims are not shareholders."

In a conclusion that may seem counter-intuitive, the author found that regular securities cases, where shareholders are the primary victims, are almost 20 percentage points more likely to be dismissed (55%) than event-driven securities cases (36%). What's more, the average shareholder settlement in event-driven securities litigation (where the misconduct most directly harms victims other than shareholders) is $24.3 million compared to $7.2 million for regular securities litigation where the primary victims are shareholders. The author noted that these correlations "persist even when controlling for firm size, class period duration, court expertise, and indicia of merits of the lawsuit, such as institutional investors as lead plaintiffs, earnings restatements within the class period, and whether the complaint cited an SEC investigation." In addition, defendant companies in event-driven securities cases are larger on average ($29.6 billion in total assets), compared to regular securities class actions on average ($8 billion in total assets). And, almost 70% of event-driven securities cases were brought by pension funds and other institutional investors, compared with only 42% of regular securities litigation. That's notable because "institutional investor lead plaintiffs are associated with lower dismissal probability and dramatically higher settlement values. They also generally appear to sue much larger firms."

The author concluded that these event-driven securities class actions are "big-ticket cases." Why is that? According to the author, probably because, in these cases, the "shareholder plaintiffs almost universally benefit from government investigations into the defendant firms' misconduct against third parties." That is, plaintiffs "piggyback" on the government's factfinding; work already performed by regulators such as the EPA, the FDA and the NHTSA means that "the bad facts are already public," making these cases prime vehicles for litigation—or, depending on your point of view, piling on by opportunistic plaintiffs. The author viewed the incidence of government investigations as "the most striking difference": although SEC investigations were cited in both types of complaints with similar frequency, over 70% of event-driven securities class actions cited only inquiries or actions by non-SEC regulators, but only 4% of regular securities class actions cited these types of inquiries. Nearly 90% of complaints in event-driven securities lawsuits cited some government investigation.

But do these cases have merit? The answer, according to the author, "is that in practice, there is usually extraordinary ambiguity in these cases about whether the shareholders were defrauded." The author contended that, although the characteristic "low dismissal rates, high settlement values, government investigations and institutional lead plaintiffs" are often considered indicia of merit, with event-driven securities litigation, that is not necessarily the case. She argued that the intense pressure to settle these cases—because of the size of the claims, the battle's being fought on several fronts and uncertainties of success, rather than merit—could account for the relatively high settlements. In addition, institutional investors, which are often the lead plaintiffs, may "cherry-pick" these cases, "not because there was clearly investor fraud, but because, thanks to the government investigations that accompany the vast majority of them, bad facts are already public, and the defendants tend to have deep pockets." Finally, the investigations performed by regulators outside of the SEC may not really provide "hard evidence of investor fraud" as compared with SEC investigations: "the fact that non-SEC regulators discover that something went wrong does not necessarily mean that investors were defrauded."

While the real solution, the author observed, would be for companies to adopt better mechanisms to prevent the underlying event that caused the injury altogether, the author offered what she considered to be a more doable policy prescription: two "targeted mechanisms that might help shareholders and the general public better monitor firm conduct that externalizes costs to third parties: more specific catastrophic risk disclosures…and mandatory ESG disclosures." (With regard to catastrophic risk disclosures, some might point out that many companies already include in their SEC filings 40- or 50-page risk factor sections that seek to do just that.) With regard to ESG disclosures, she argued that the absence of mandatory uniform requirements has made ESG disclosures difficult to evaluate and compare and allowed companies to engage in greenwashing. However, the author suggests, if companies "undertake, in measurable terms, to be responsible citizens, there may be less leeway for them to maintain operational risks that could result in harm to third parties." Accordingly, she contends, providing better information about the "measures firms take to be responsible corporate citizens…would enable shareholders and the general public to better monitor these risks."

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