

Do the Merits Matter More?

Class Actions under the Private
Securities Litigation Reform Act

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Do the merits matter in securities class actions?

✧ Alexander (1991) says no

- Lack of variation in settlements

✧ Corporate issuers say no

- Suits based simply on stock price drop

✧ Accountants and underwriters say no

- Targeted as “deep pockets”

Response

- ✧ Settlements higher in cases of flagrant fraud (Marino & Marino, 1994)
- ✧ Not all price declines lead to suit (Francis et al. 1994; Jones & Weingram, 1996)
- ✧ Plaintiffs' lawyers have incentives to bring strong cases (Lerach & others, many times)

Congress and the PSLRA

✧ Finding:

- Plaintiffs' bar was hurting companies and investors with frivolous lawsuits

✧ Response:

- Tougher pleading standards
- Safe harbor for forward-looking statements
- Discovery stay to discourage “fishing expeditions” and “extortionate settlements”

Reaction to the PSLRA



✧ Clinton veto

- Positive market reaction to override (Johnson et al., 2001)
- ✧ No decline in filings (NERA, 2000)
- ✧ More accounting and insider trading allegations (Grundfest & Perino, 1997; PWC, 2000)
 - Insider trading allegations tend to be dismissed (Pritchard & Sale, 2003)

Hypotheses

- H1: Aggressive accounting, insider trading, and governance factors are more important in explaining lawsuit filings
- H2: Forecasts are less important in explaining lawsuit filings
- H3: Aggressive accounting and insider trading are more important in explaining allegations of accounting fraud and insider trading
- H4: Earnings shortfalls will be less important in explaining allegations of false forward-looking statements.
- H5: Accounting, insider trading, and governance factors are more important in explaining lawsuit outcomes
- H6: Forecasts and earnings shortfalls are less important in explaining lawsuit outcomes

Sample

- ✧ Computer hardware and software firms
- ✧ Need proxies, data from CRSP, Compustat
 - Sample construction excludes IPO firms
- ✧ Number of suits
 - Pre-PSLRA [1991-1995]: 50
 - Post-PSLRA [1996-2000]: 64
- ✧ Matched with non-sued firm
 - Same SIC code, similar price drop

Model

- ✧ Damages, accounting, insider trading and governance variables
 - Previously found to correlate with litigation and/or SEC enforcement actions
 - SEC actions proxy for fraud
- ✧ Forecasting variables
 - Attempting to capture the effect of the safe harbor

Damages Variables

✧ *Market Cap. (+)*

- Log of market value of common equity

✧ *Min. Return (-)*

- Minimum return for 250 trading days ending with class period end

✧ *Turnover (+)*

- Average daily trading volume divided by number of shares outstanding

Accounting Variables

✧ *Restatement (+)*

- Earnings restated for class period

✧ *Audit Meetings (–)*

- # meetings year prior to class period

✧ *Audit Independence (–)*

- % outsiders on audit committee

Insider Trading Variables

✧ *Insider Trading* (–)

- Net sales during class period by decile rank

✧ *Abnormal Insider Trading* (–)

- Net sales normalized by prior trading practices by decile rank

Forecasting Variables

✧ *Earnings Shortfall (+)*

- Negative forecast on minimum return or class end date

✧ *Positive Forecast (+)*

- Positive forecast during class period

✧ *Negative Forecast (-)*

- Negative forecast during class period other than minimum return or class end date

Governance Variables

✧ *Avg. Tenure* (–)

- Average years on board

✧ *Busy* (+)

- Average number of boards

✧ *Independent* (–)

- % of outsiders on board

Filing

Significant Variables

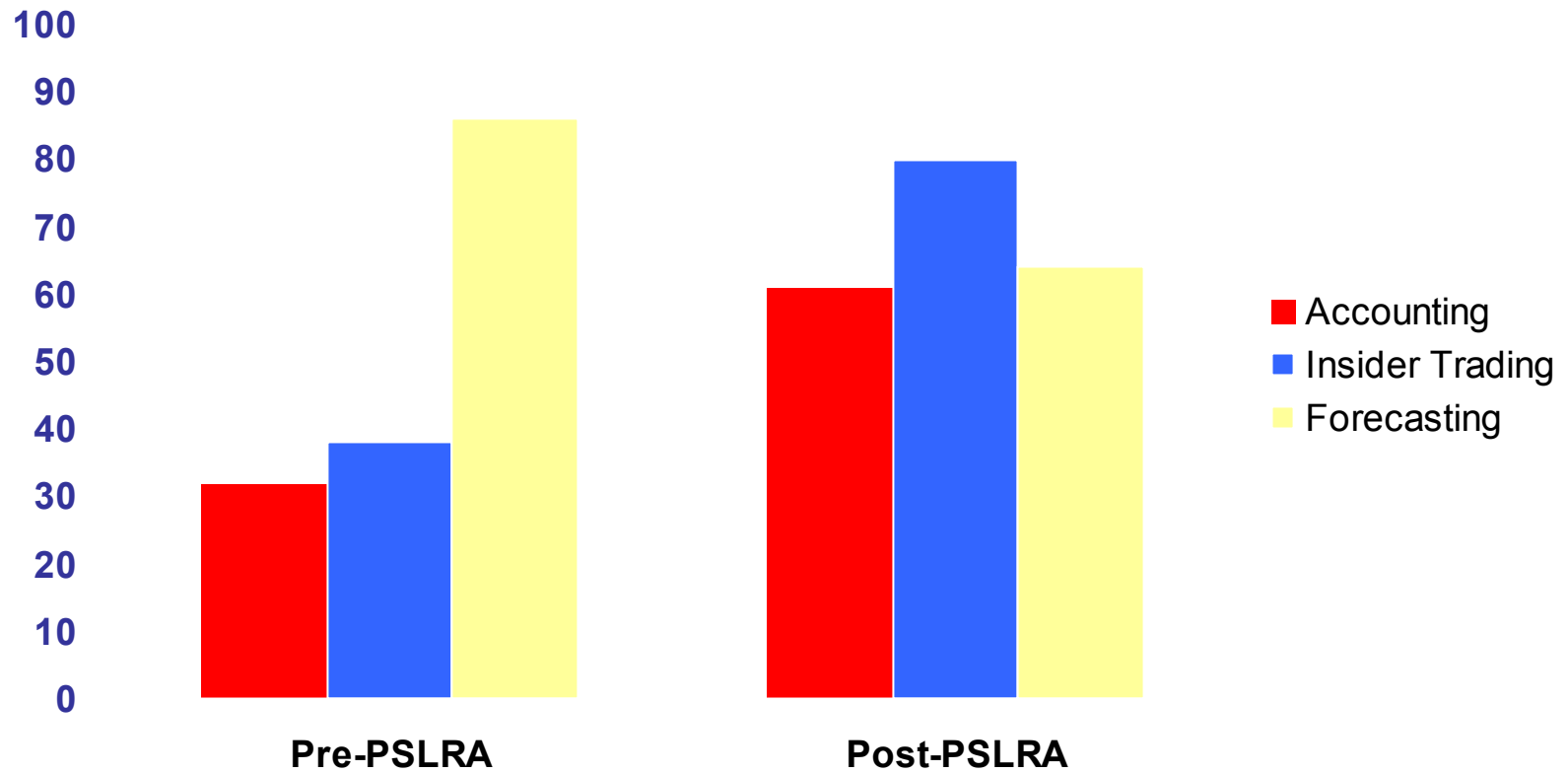
✧ *Pre-PSLRA*

- *Market Cap. (+)*
- *Positive Forecast (+)*
- *Earnings Shortfall (+)*

✧ *Post-PSLRA*

- *Market Cap. (+)*
- *Min. Return (-)*
- *Restatement (+)*
- *Insider Trading (-)*
- *Earnings Shortfall (+)*
- *Busy (+)*
- *Independent (-)*

Allegations



Allegation Regressions

- ✧ Damages variables omitted from models
- ✧ Dependent variables:
 - Accounting allegation
 - Insider trading allegation
 - Forecasting allegation

Accounting Allegations

Significant Variables

✧ *Pre-PSLRA*

- None

✧ *Post-PSLRA*

- *Restatement (+)*
- *Forecasting allegation (-)*
- *Audit Independence (+)*

Insider Trading Allegations

Significant Variables

✧ *Pre-PSLRA* ✧ *Post-PSLRA*

● *Busy (+)*

● *Insider trading (–)*

● *Forecasting allegation (–)*

Forecasting Allegations

Significant Variables

✧ *Pre-PSLRA*

- *Earnings shortfall (+)*

✧ *Post-PSLRA*

- *Earnings shortfall (+)*
- *Accounting allegation (-)*
- *Insider trading allegation (-)*

Do the merits drive outcomes?

✧ Damages variables excluded

✧ Dependent variable:

- Settlement

- Dismissal or “nuisance” settlement (<\$2M.)

Outcome

Significant Variables







✧ *Pre-PSLRA*

- *Abnormal Insider Trading (-)*
- *Negative Forecast (+)*
- *Avg. Tenure (-)*

✧ *Post-PSLRA*

- *Restatement (+)*
- *Avg. Tenure (-)*

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Conclusion

- ✧ Merits matter somewhat more post-PSLRA
- ✧ Accounting, insider trading and governance variables become significant post-PSRLA in explaining:
 - Filings
 - Allegations
- ✧ Safe harbor offers some protection for forecasts

Caveats

- ✧ Outcomes show no clear shift
 - *Abnormal Insider Trading* significant pre-Act for outcomes
- ✧ Methodology does not capture suits not filed
- ✧ *Insider Trading* significant rather than *Abnormal Insider Trading*
- ✧ Model does not explain all variation

TABLE 1
Descriptive Statistics on Lawsuits

<i>Panel A: Number of filings and allegations</i>								
Lawsuit Year		Number of Suits		Accounting Allegations		Insider Trading Allegations		Forecasting Allegations
<i>Pre-PSLRA:</i>								
1991		10		3 (30.0%)		3 (30.0%)		9 (90.0%)
1992		8		2 (50.0%)		4 (50.0%)		8 (100%)
1993		11		3 (27.3%)		1 (09.0%)		10 (90.9%)
1994		10		5 (50.0%)		6 (60.0%)		9 (90.0%)
1995		11		3 (27.3%)		5 (45.5%)		7 (63.6%)
		50		16 (32.0%)		19 (38.0%)		43 (86.0%)
<i>Post-PSLRA:</i>								
1996		11		6 (54.5%)		9 (81.8%)		7 (63.6%)
1997		15		8 (53.3%)		11 (73.3%)		9 (60.0%)
1998		15		9 (60.0%)		11 (73.3%)		10 (66.7%)
1999		15		10 (66.7%)		13 (86.7%)		10 (66.7%)
2000		8		6 (75.0%)		7 (87.5%)		5 (62.5%)
		64		39 (60.9%)		51 (79.7%)		41 (64.1%)
Total		114		55 (48.2%)		70 (61.4%)		84 (73.7%)

<i>Panel B: Lawsuit outcomes</i>		
Outcome	Pre-PSLRA (N=50)	Post-PSLRA (N=64)
Dismissed	17 (34.0%)	24 (37.5%)
Settled (in millions):		
< 2	5	4
2 – < 5	3	11
5 – < 10	10	7
>10	13	15
Undisclosed or bankrupt	2	2
Pending	0	1
Mean (including dismissals)	9.88 (6.38)	21.41 (12.99)
Median (including dismissals)	8.00 (3.05)	6.00 (2.26)
Maximum	55.00	259.00
Minimum	0.64	< 0.01

Table 3
Determinants of Lawsuit Filings

Variable	Prediction	Pre-PSLRA		Post-PSLRA	
		Coeff.	p-value	Coeff.	p-value
Constant	?	-4.90	< 0.01	-2.52	0.02
Market Cap.	+	0.46	< 0.01	0.33	< 0.01
Min. Return	-	-3.05	0.19	-3.41	0.03
Turnover	+	1.05	0.21	0.12	0.88
Restatement	+	1.62	0.17	2.80	< 0.01
Insider Trading	-	0.01	0.52	-0.01	0.03
Abnormal Insider Trading	-	0.01	0.38	-0.01	0.25
Positive Forecast	+	0.84	0.07	0.22	0.61
Negative Forecast	-	-1.00	0.57	-0.31	0.58
Earnings Shortfall	+	1.31	0.01	1.19	< 0.01
Avg. Tenure	-	-0.06	0.22	0.02	0.74
Busy	+	0.08	0.72	0.39	0.05
Independent	-	-0.78	0.72	-2.36	0.09
Audit Meetings	-	-0.01	1.00	0.10	0.32
Independent Audit	-	-0.76	0.93	0.40	0.67
Pseudo R ²		0.54		0.56	
N		100		128	

TABLE 4
Determinants of Accounting, Insider Trading
and Forecasting Allegations Conditional on a Lawsuit Filing

Panel A: Determinants of accounting allegations

Variable	Prediction	Pre-PSLRA		Post-PSLRA	
		Coeff.	p-value	Coeff.	p-value
Constant	?	-1.84	0.14	-0.24	0.82
Insider Allegation	+	0.49	0.27	-0.48	0.34
Forecasting Allegation	-	-0.12	0.88	-0.83	0.07
Restatement	+	5.80	0.98	0.99	0.03
Avg. Tenure	-	0.03	0.74	0.01	0.86
Busy	+	0.13	0.62	-0.14	0.46
Independent	-	0.04	0.98	-0.27	0.83
Audit Meetings	-	0.03	0.81	-0.06	0.50
Audit Independence	-	0.72	0.54	2.00	0.06
Pseudo R ²		0.23		0.27	
N		50		64	

Panel B: Determinants of insider trading allegations

Variable	Prediction	Pre-PSLRA		Post-PSLRA	
		Coeff.	p-value	Coeff.	p-value
Constant	?	-1.72	0.16	1.69	0.18
Accounting Allegation	+	0.68	0.12	-0.65	0.18
Forecasting Allegation	-	0.10	0.86	-0.95	0.06
Insider Trading	-	-0.01	0.60	-0.01	0.10
Abnormal Insider Trading	-	0.01	0.69	-0.01	0.69
Avg. Tenure	-	-0.09	0.22	-0.06	0.42
Busy	+	0.42	0.06	0.16	0.45
Independent	-	1.60	0.34	1.71	0.21
Audit Meetings	-	-0.13	0.30	0.01	0.95
Audit Independence	-	0.15	0.88	-0.22	0.84
Pseudo R ²		0.19		0.15	
N		50		64	

Panel C: Determinants of forecasting allegations

Variable	Prediction	Pre-PSLRA		Post-PSLRA	
		Coeff.	p-value	Coeff.	p-value
Constant	?	0.28	0.88	1.29	0.26
Accounting Allegation	–	–1.97	0.09	–1.24	<0.01
Insider Trading Allegation	–	0.36	0.69	–1.04	0.05
Positive Forecast	+	1.36	0.21	0.20	0.64
Negative Forecast	–	0.08	0.93	–0.21	0.70
Earnings Shortfall	+	2.85	0.01	0.93	0.04
Avg. Tenure	–	0.06	0.68	–0.12	0.10
Busy	+	0.08	0.81	0.06	0.78
Independent	–	–1.49	0.66	–1.67	0.30
Audit Meetings	–	0.15	0.55	0.03	0.80
Audit Independence	–	–0.80	0.78	1.87	0.12
Pseudo R ²		0.33		0.26	
N		50		64	

TABLE 5
Determinants of Lawsuits Settled for Greater Than Nuisance Value (> \$2 Million)

Variable	Prediction	Pre-PSLRA		Post-PSLRA	
		Coeff.	p-value	Coeff.	p-value
Constant	?	-0.62	0.66	-0.19	0.85
Restatement	+	0.25	0.77	0.73	0.08
Insider Trading	-	0.01	0.10	-0.00	0.59
Abnormal Insider Trading	-	-0.01	0.04	0.00	0.92
Positive Forecast	+	-0.94	0.11	0.58	0.18
Negative Forecast	-	1.44	0.01	0.04	0.92
Earnings Shortfall	?	-0.82	0.34	0.34	0.41
Avg. Tenure	-	-0.16	0.05	-0.16	0.04
Busy	+	-0.00	0.99	0.16	0.42
Independent	-	2.06	0.39	-1.13	0.40
Audit Meetings	-	0.19	0.25	0.01	0.89
Independent Audit	-	1.04	0.38	0.95	0.35
Pseudo R ²		0.38		0.17	
N		48		61	