Harvard Law School Forum on
Corporate Governance and Financial Regulation

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Event-Driven Litigation Defense

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Editor's note: Julie G. Reiser and Steven J. Toll are partners at Cohen Milstein Sellers & Toll PLLC. This post is based on their recent Cohen Milstein memorandum.

The authors address criticism of shareholder lawsuits presented in two recent reports by the U.S. Chamber's Institute for Legal Reform ("ILR"). Released in October 2018 and February 2019, the ILR reports emphatically urge Congress, the Securities and Exchange Commission, and federal judges to act to curb a "contagion" of "abusive" securities class action litigation.

Reiser and Toll focus on securities lawsuits that have been targeted by the ILR as nuisance cases that warrant legislative intervention. These "event-driven" lawsuits seek to compensate shareholders, who allege that a company has recklessly concealed or misrepresented business or operational risks, leading to a catastrophic event that, among other things, drives down the company's stock price. Examples include the BP Deepwater Horizon disaster, where the company for years had failed to implement safety systems despite repeated public claims to the contrary. Reiser and Toll find that the ILR relies on flawed logic and circular reasoning to argue that the legislature must intervene to limit these cases rather than allowing the courts to make such determinations. Indeed, many of these suits provide an important remedy for investors and have resulted in large settlements that could not have been achieved otherwise.

The purported mission of the U.S. Chamber of Commerce's Institute for Legal Reform ("ILR") is to bring about "civil justice reform" by, among other things, lobbying Congress to limit investors' access to the courthouse. For decades, the ILR has allied itself with powerful publicly traded corporations under the pretext of protecting their defrauded investors. The ILR's latest campaign, like so many of its previous endeavors, relies on the illogical premise that investors and the economy are harmed by securities fraud litigation rather than by corporate fraud and malfeasance. In two reports authored by Mayer Brown Partner Andrew Pincus, *A Rising Threat the New Class Action Racket that Harms Investors and the Economy* (October 2018) [1] and Containing the Contagion, Proposals to Reform the Broken Securities Class Action System (February 2019) [2], the ILR asserts that the 1995 Private Securities Litigation Reform Act ("PSLRA") has failed to curtail meritless securities lawsuits and that Congress therefore must place additional constraints on investors' ability to hold companies accountable for fraud.

[1] U.S. Chamber Institute for Legal Reform: A Rising Threat: The New Class Action Racket That Harms Investors and the Economy (October 24, 2018) https://www.instituteforlegalreform.com/research/a-rising-threat-the-new-class-action-racket-that-harms-investors-and-the-economy

[2] U.S. Chamber Institute for Legal Reform: *Containing the Contagion: Proposals to Reform the Broken Securities Class Action System* (February 25, 2019): https://www.instituteforlegalreform.com/research/containing-the-contagion-proposals-to-reform-the-broken-securities-class-action-system

Citing the increase in the number of securities-related lawsuits over the past several years, the ILR argues that courts should not be permitted to separate the meritorious cases from the weak and that certain types of cases must be scaled back through legislation. Both ILR reports specifically target federal securities class actions that: (i) challenge M&A transactions; and (ii) arise from corporate disasters. This article focuses only on the category of lawsuits the ILR calls "event-driven litigation."

The ILR insists that cases involving corporate disasters "*extort* large settlements" from corporations for meritless claims. That bold assertion conveniently ignores the fact that many cases of this type have settled only after hard-fought litigation in which the corporate defendants were vigorously represented by lawyers from the country's most elite law firms, making the ILR's efforts to victimize the companies even more of a distortion. Contrary to the ILR's claims, the existence of "event-driven litigation" simply reflects the reality that when companies behave recklessly, there often are two groups of victims: individuals who suffer personal or property injuries, and shareholders who sustain investment losses.

The ILR's assertion that the increase in event-driven litigation causes damage to investors and companies, rather than reflect it, is as fundamentally unsound as the idea that the number of firefighters dispatched to a fire causes greater fire damage. To the contrary, event-driven cases serve as a deterrent to companies who might otherwise conceal or misrepresent their operations because they recognize that investors will hold them accountable for doing so.

"Event-Driven Litigation" Describes Almost Any Securities Fraud Action that Does Not Arise from an Accounting Restatement

So-called "event-driven litigation" describes cases in which a company recklessly concealed or misrepresented the risk of a major negative event, making statements touting its strong safety policies and procedures, for example, or its compliance with the law. When dangerous operations or illegal conduct are exposed—often because of a catastrophic event—the market reacts negatively and artificial inflation dissipates from the stock price, damaging investors who relied on the false or misleading statements. These cases are distinguishable from accounting fraud cases, where typically the company itself reveals internal misconduct. Recent examples of big accounting restatements include those announced by Valeant and American Realty Capital Properties, both of which resulted in criminal convictions of company executives.

However, high-profile securities fraud cases also arise from adverse events which reveal that a company has recklessly misrepresented its compliance with the law (*e.g.*, the *Petrobras* case discussed below) or the quality of its loans or underwriting practices (as in, for example, the mortgage-backed securities fraud cases against large Wall Street banks). In the past, allegations that a company had "cooked the books" were the primary basis for securities fraud actions. That no longer is the case, however. Since 2006, U.S. corporations have reduced the number of restatements by one-third, likely both because regulations have become more stringent and because executives have become more creative in concealing the truth. [3]

In fact, the ILR's contention that the only legitimate securities fraud claims are based on false financial reporting or accounting violations has twice been rejected by the Supreme Court, which

[3] https://www.auditanalytics.com/blog/2016-financial-restatements-review/.

has explicitly recognized that “an adverse event . . . can be the basis for a securities fraud class action” (in *Matrixx Initiatives, Inc. v. Siracusano*, in 2011, and in *Omnicare Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, in 2015). And, the ILR’s conclusion that so-called “event-driven” cases are somehow a problem requiring legislation is also belied by the numerous successful “event-driven” securities fraud cases that resulted in substantial recoveries for shareholders. For example, Brazilian state-owned energy company Petróleo Brasileiro S.A. (“Petrobras”) paid more than $2.95 billion in 2018 to resolve private securities fraud claims based on its undisclosed illegal conduct.

In *Petrobas,* the plaintiff investors alleged that company executives organized a vast kickback and bid-rigging scheme which involved over a dozen companies and many of Brazil’s leading political figures. Despite writing off nearly $20 billion, Petrobras never restated its financials. However, even without a financial restatement, the *Petrobras* district court observed that the concealment of an unlawful transaction can be considered a material misrepresentation, particularly where the massive asset write-down threatened the viability of the company. The court also found that Petrobras’ representations concerning its integrity and high ethical standards were actionable under the federal securities laws because they were designed to reassure investors who relied on the statements’ veracity and the company’s stability.

The *Petrobras* case is merely one example of successful “event-driven” litigation; statistics show that of the 100 top securities fraud settlements of all time, 59% *did not* involve a restatement. *See* ISS, *The Top 100 U.S. Class Action Settlements of All-Time*, as of 31 December 2017, at 33. Accordingly, the argument that securities fraud cases should be limited to instances of accounting fraud would leave defrauded investors in a majority of cases without any recourse.

The Fact that a Company Faces Liability for an Underlying Event Doesn’t Mean Its Investors Should Go Without Relief

The ILR also relies on circular logic to conclude that unexpected events are, by definition, unexpected. As a result, it contends, it would be unfair to assume that a company recklessly concealed the risk of a catastrophic event from investors. This argument too is belied by evidence uncovered in the *BP* and various mortgage-backed securities actions. Notably, that evidence would not have been discovered had plaintiffs’ counsel not first been able to adequately plead claims that the courts found were sufficiently strong to withstand motions to dismiss.

The securities fraud class action against BP arose from the *Deepwater Horizon* explosion—the largest environmental disaster in U.S. history. Investors claimed that BP recklessly concealed the true likelihood of a catastrophic event. In that case, following a series of catastrophic events, BP repeatedly told investors that it would prioritize process safety through a state-of-the-art Operating Management System (“OMS”) that the company would implement “across all of BP’s operations.” In discovery, investors learned that BP in fact had no intention of implementing OMS on contracted vessels, which were used for BP’s most dangerous deep-sea drilling operations. Because BP contracted with Transocean, OMS did not apply to the *Deepwater Horizon,* which meant that BP did not have a viable Oil Spill Response Plan, as required by its frequently touted OMS. Thus, not only did BP fail to prevent a catastrophic event but then once the Deepwater

Horizon explosion occurred, unbeknownst to its shareholders, BP did not have a plan in place to mitigate the disaster. [4]

BP settled the mass tort claims for $20 billion. However, its shareholders were able to credibly claim that they had been injured as a result of BP's misrepresentations regarding its safety systems. Although the district court denied plaintiffs' motion for class certification on those claims, the judge did permit investors to pursue fraud claims if they established they would not have purchased BP stock had they known the truth about the limited application of OMS. [5]

Likewise, there were more than a dozen mortgage-backed securities class action cases filed by private plaintiffs against Wall Street banks for knowingly misrepresenting their underwriting standards, resulting in AAA-rated bonds. The banks' misrepresentations about their increasingly lax underwriting standards contributed to the financial crisis by enabling unqualified borrowers to obtain mortgages. The banks then churned those poorly underwritten loans through mortgage-backed securities and other securitizations, which investors purchased before the securities plummeted in value in 2008. While *The Economist* estimates that from 2008 through October 2013, U.S. banks agreed to pay $95 billion in mortgage-related penalties, investors were also able to use private litigation to recoup some of the losses they sustained as a result of the banks' misrepresentations concerning their underwriting standards. As a result of these shareholder class actions, banks agreed to pay more than $3 billion in private settlements with classes of investors who purchased the mortgage-backed securities.

Meritorious Securities Fraud Claims Ensure Truthful Corporate Statements and Accountability

As the cases discussed above illustrate, the ILR's assertion that congressional and regulatory action is needed to curb "abusive" securities class actions because such cases "are imposing huge costs on investors without providing any benefit" is wholly unfounded. Moreover, the importance of private securities fraud actions is underscored by the fact that, from 2006 through 2018, securities class actions have generated more than $101 billion in investor recoveries. [6] Overall, the monies recovered for investors through private class actions dwarf the monies investors have recovered through SEC disgorgements, the top 50 of which collectively total less than $11 billion. [7] In addition, the ILR's contention that shareholder litigation is a costly and indiscriminate drain on businesses is belied by the facts. A recent statistical analysis, for example, found that "[e]xposure of public corporations to alleged violations of the federal

[4] The U.S. Chemical Safety Board concluded, "BP had multiple safety management system deficiencies that contributed to the Macondo incident."https://www.csb.gov/csb-investigation-at-the-time-of-2010-gulf-blowout-transocean-bp-industry-associations-and-government-offshore-regulators-had-not-effectively-learned-critical-lessons-from-2005-bp-refinery-explosion-in-implementing-safety-performance-indicators/

[5] The "post-spill" portion of the case alleged that BP misrepresented the amount of oils spilling into the Gulf of Mexico and settled for $175 million, after a summary judgment ruling. Likewise, an Amended Complaint was filed in a securities fraud action against PG&E, which alleges that PG&E misled investors in trying to assuage their concerns about PG&E's liability for the Northern California wildfires when the company claimed it complied with all laws and subsequently received criminal referrals by CalFIRE. PG&E has since announced that the Securities and Exchange Commission is investigating whether it misrepresented its compliance with the securities laws. https://www.nytimes.com/2019/05/02/business/energy-environment/pge-sec-investigation.html [Ivan Penn, *PG&E Says S.E.C. Is Investigating Its Wildfire Disclosures,* New York Times, May 2, 2019]

[6] See ISS Securities Class Action Services, https://www.issgovernance.com/securities-class-action-services/ and https://www.issgovernance.com/library/the-top-100-u-s-settlements-of-all-time-as-of-december-2018/.

[7] Securities Class Action Services, "The Top 100 U.S. Class Action Settlements of All Time As of December 2018," https://www.issgovernance.com/library/the-top-100-u-s-settlements-of-all-time-as-of-december-2018/.

securities laws under Section 10(b) and 20(a) of the Securities Exchange Act of 1934 is approximately one quarter of a percentage point of the aggregate market capitalization of U.S.-based corporations." [8]

While the ILR bemoans the cost of defending securities fraud actions, it also must acknowledge that legislation like the Sarbanes-Oxley Act of 2002 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 were enacted *after* the PSLRA to heighten corporate duties and assist private plaintiffs in their ability to obtain relief. These reforms were enacted because fraud continued to be prevalent. Further underscoring the value of private investor enforcement of the securities laws, an empirical study found that private class actions resulted in higher incidences of top officer resignations than SEC investigations. [9]

The ILR's claim that the increase in securities fraud filings reflects the need for a legislative remedy misapprehends correlation for causation. Although the number of filings has increased and the number of financial restatements has declined, it would be inaccurate to say that, therefore, legislative remedies must curtail meritless securities fraud actions. The fact that private securities actions are on the rise is not a reason to legislate against "event-driven" litigation because frequently investors are also injured when a corporation misrepresents the risks associated with its operations. As the ILR's own statistical data regarding dismissal rates shows, courts are more than capable of weeding out the weak cases from the strong and, as historic mega-settlements show, the strong ones should proceed.

[8] Nessim Mezrahi, *Exposure To Market Fraud Suits Is Not A Major Risk,* Law360, February 21, 2019. https://www.law360.com/securities/articles/1131222%3Cimage004.jpg%3.

[9] Stephen J. Choi and Adam Pritchard, *SEC Investigations and Securities Class Actions: An Empirical Comparison*¸ Journal of Empirical Legal Studies, Volume 13, Issue 1, 27–49, March 2016.
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