



The rise in event-driven securities litigation — Why it matters to directors and officers

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I. Introduction

There has been a significant shift in the nature and quality of securities class actions, from traditional accounting fraud cases predicated on allegedly misstated financial statements, to non-accounting cases based on adverse news and events.

Understanding this shift is important for public companies and their directors and officers so that they can better assess and mitigate risks, and better manage what they say (or do not say) in their public filings and statements, and in response to an event.

II. The changing landscape

In 1996, there were 7,439 U.S. publicly traded companies.² That number declined to 4,697 by 2006, and to 3,616 by 2017.³ In addition, the number of reissuance restatements filed by public companies has declined for the eleventh year in a row, with only 10% of the number of reissuance restatements in 2017 that existed in 2006.⁴ These numbers might suggest that shareholder class actions should also be on the decline.

On the contrary, 2017 was a near record year for securities class action filings.⁵ Indeed, the likelihood that a public company will be sued in a securities class action in any given year has risen from 3.5% in 2014 to around 8.5% at the end of the first half of 2018.⁶

While the chance of a public company and its directors and officers being sued for alleged securities violations is on the rise, studies show that there are fewer and smaller settlements, and the highest number of dismissals and withdrawals since the early 2000s.⁷

The explanation for these numbers lies in the shift in the nature of securities class actions from traditional accounting-based allegations related to revenue recognition, improper allowance for losses, delayed asset impairment, or other violations of generally accepted accounting principles, to those filed in response to adverse company events, such as a data security breach, sexual harassment allegations, an explosion, allegations that a drug or product has side effects or caused injury, or a regulatory investigation or enforcement action.⁸

The inherent problem in all event-driven securities litigation is that just because something bad happened does not mean that the company or its directors and officers committed fraud. Because many of these events relate to business or operational risks that are known or already subject to a company's risk disclosures, many of the event-driven suits are based on the tenuous theory that the occurrence or the event upon which the case is based was the materialization of an under-disclosed or downplayed risk.

These non-financial misstatement cases based on adverse events are generally weaker than traditional accounting misstatement cases and have a higher dismissal rate than financial misstatement cases, with the dismissal rate approaching 60%.⁹ While greater likelihood of dismissal provides some comfort, not all cases are dismissed, and even those that are dismissed come with significant cost and disruption to a company.

Notably, these event-driven cases have been litigated disproportionately by a group of firms that until 2009 had a very small share of the federal securities class action market, but whose share has increased substantially since then from 6% of all filings to over 40%.¹⁰ These firms do not have relationships with the major institutional investors and, therefore, have little chance of controlling larger cases involving financial irregularities. As a result, they focus on cases involving adverse events that institutional investors do not typically bring.¹¹ Moreover, since event-driven litigation often follows personal injury or consumer cases, securities plaintiffs' firms that bring event-driven cases can often "free ride" on the discovery in those cases. As such, the higher dismissal rates of event-based securities class actions are unlikely to deter future, similar filings as these plaintiffs' firms have few options of which cases to file.

However, through examination of some of the recent event-based litigation, public companies and their directors and officers can mitigate the risks of suit, or bolster chances of early success.

III. Examples of significant event-driven securities litigation

A. Cyber security

In Willis Towers Watson's 2018 Management Liability (Directors and Officers) U.S. Survey, cyber-related risks were by far the greatest concern to directors and officers.¹² While consumer litigation has become common following a data breach, investor suits have generally been limited to sporadic derivative suits alleging that the company's board failed to properly oversee the company's cyber risks. Those few derivative suits that were filed over the last several years have generally been dismissed early in the case. However, since 2017, there have been at least nine direct (not derivative) federal class action securities fraud cases filed after data security incidents. Unlike many of the prior derivative actions, disclosures of the breaches were accompanied by drops in stock price.

In cyber event-driven securities litigation, generally, a company's stock price drops after disclosure of either a data breach or an alleged data security vulnerability. Plaintiffs allege that the pre-breach public disclosures did not adequately disclose the risk of a data security incident, or that the company overstated its cyber security-related strengths or capabilities. Often, it is also alleged that the company withheld or was too slow in disclosing a breach after it was detected.

These cases present the question of whether an alleged failure to disclose a specific security vulnerability is actionable where the company has disclosed, as a general matter, the potential risks connected to a data or security breach. Companies should watch the current cyber security related cases closely as they may provide helpful guidance on crafting appropriate disclosures about the range of data security risks a company faces. In addition, when faced with a breach or security issue, companies must balance competing interests of timely disclosures to the market with making sure that they take the necessary time to investigate so that the disclosures are accurate. Documenting that process in a thoughtful way is critical to combatting allegations of delay.

Additionally, in February 2018, the U.S. Securities and Exchange Commission (SEC) issued a statement and interpretive guidance to assist public companies in preparing disclosures about cybersecurity risks and incidents.¹³

In light of the current litigation climate and the SEC's interpretive guidance, management should conduct a review of the company disclosure processes and procedures, and review risk factor disclosures to make sure they match the company's actual risk and are not boilerplate disclosures of cyber-related risks.

B. Alleged sexual harassment or abuse

A number of recent cases have alleged securities law violations or breaches of fiduciary duty based on sexual harassment or sexual abuse allegations.¹⁴ The claims are predicated on the alleged failure of companies to address or disclose a systemic culture of sexual harassment or abuse by executives and others. Shareholders claim that, when the conduct was finally disclosed, they were damaged by the avalanche of lawsuits that could have been avoided or minimized, fleeing talent and damage to good will.

Directors and officers should ensure that the company: (1) takes all allegations of sexual misconduct seriously and conducts a thorough, unbiased, investigation – potentially with independent outside investigators; (2) obtains legal advice about whether the allegations of sexual misconduct or the internal investigative findings should be disclosed, particularly if they involve high-level employees or systemic sexual misconduct; and (3) reviews, and is mindful of, its relevant public statements, including risk factor disclosures, regarding the company’s compliance with applicable law and internal ethics standards to avoid unnecessarily triggering a potential duty to disclose, and to determine if and when disclosure is required.

C. Explosions or environmental disasters

The largest class action settlement in 2017 was by BP p.l.c. over the Deepwater Horizon explosion. BP was alleged to have misstated the effectiveness of its safety procedures prior to the spill, creating an impression that the risk of a catastrophic failure was lower than it was.

In a somewhat older case (but based on a similar theory) against Massey Energy in 2010, the parties settled a case brought following a mine explosion that killed two and later produced a criminal conviction of Massey’s CEO. Plaintiffs alleged that Massey made false and misleading statements during the class period about its commitment to safety and safety initiatives, including through its public campaign on “safety over production” that touted its safety improvement initiatives to investors.

These cases present issues similar to those in the cyber security cases about how specific disclosures should be regarding particular risks.

D. Bribery or corruption cases

Civil suits are frequently filed after company announcements of the beginning of a bribery investigation or enforcement action. While most of these cases are unsuccessful, a few are noteworthy.

In the highly publicized *In re Petrobras Securities Litigation*,¹⁵ the driving force behind the litigation was when Brazilian newspapers reported that Brazilian federal police had arrested a retired executive as part of a crackdown on black-market money laundering. Petrobras did not mention the incident explicitly in its annual report filed the following month, saying only that it was conducting routine internal investigations into certain issues. The litigation centered on allegations that Petrobras had concealed this bribery and kickback scheme from investors. Petrobras eventually agreed to pay \$2.95 billion.¹⁶

In 2015, the United States Supreme Court decided *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund* and found that a statement of opinion that the company “believed” itself to be in compliance with the law could be materially misleading if investors assumed that this statement implied that the company had made a procedurally adequate investigation to support its views. Omnicare stated in its public filings that (1) “[w]e believe our contract arrangements with other healthcare providers, our pharmaceutical suppliers and our pharmacy practices are in compliance with applicable federal and state laws;” and (2) “[w]e believe that our contracts with pharmaceutical manufacturers are legally and economically valid arrangements that bring value to the healthcare system and the patients that we serve.” Both statements were accompanied by cautionary language that governmental entities, both through words and legal action, had taken issue with certain of these practices, and that the legal landscape could therefore change in the future. When Omnicare’s stock price fell after a federal raid on the company to seize evidence, the earlier statement of opinion as to compliance with the law was used by plaintiffs to show a misleading statement or omission. The Supreme Court found Omnicare’s omissions actionable, stating, “to avoid exposure for omissions...an issuer need only divulge an opinion’s basis, or else make clear the real tentativeness of its belief.”¹⁷

Recently, lawsuits also have been filed against companies based on disclosures related to FCPA investigations, or the execution of search warrants by government agencies.

The best defense against these cases, besides complying with the law, is to be sure to document the basis for any statements that management believes the company is in compliance with the law.

E. Products causing health risks

Several cases have been filed that include allegations against pharmaceutical and medical device companies alleging that there were undisclosed health risks caused by products and that shareholders were harmed when this information was eventually disclosed.

For example, in 2011, the United States Supreme Court held in *Matrix Initiatives, Inc. v. Siracusano*¹⁸ that materiality could be alleged by omission and that even though adverse reports about Zicam Cold Remedy and the loss of sense of smell were not statistically significant, the possible association was still material because independent medical researchers had begun to sound the alarm.

Similarly, another recent case started with a news report about documents unsealed in personal injury litigation, which plaintiffs claimed showed that the company knew for some time that its products could cause health issues. Plaintiffs' allegations relied on a press release issued by personal injury lawyers who had sued the company.

IV. Tips for directors and officers to minimize and mitigate the risk of event-driven securities litigation

1. Reevaluate public statements about the effectiveness of your practices. Whether related to a technology company's data security practices, an energy company's safety practices or a pharmaceutical company's drug risk disclosures, plaintiffs are increasingly asserting the same underlying theory that companies had "under-disclosed" risks. Even where a risk may have been identified, plaintiffs argue that the disclosure downplayed its likelihood or the ramifications if materialized. While it may not be prudent to draft doomsday disclosures for all specific risks and outcomes, no matter how small, taking a fresh, critical look at risk disclosures is a prudent way to ensure that if a suit is brought, a company is not relying on boiler plate disclosures, and is not caught off guard having made dated statements that no longer provide a complete picture, or statements without basis.

2. Ensure all affirmative statements have support. As we see from the Omnicare case, even benign statements, such as a company stating its belief that it is complying with the law, will be challenged in the current environment if there are later allegations of wrongdoing. Ensure that for all statements, the company conducted a procedurally adequate investigation to support its views.

3. Ensure your insurance coverage does not have gaps. Some claims, like those involving sexual harassment or abuse, or harmful drug defects, may be based on conduct that occurred long in the past. Companies need to make sure that, as policies are renewed, there are no gaps in coverage and that their existing policies will cover any claims that may arise based on past acts/events. Standard policies may not be sufficient in all cases, so directors and officers need to explore whether existing coverage or riders are necessary to mitigate these risks.

V. Conclusion

Given the changing landscape, there is no silver bullet that directors and officers of public companies can employ to ward off all securities litigation but following these steps will make it harder for plaintiffs to target companies and will strengthen their defenses.

Sources

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²Wursthorn, M. and Zuckerman, G. "Fewer Listed Companies: Is That Good or Bad for Stock Markets?" *The Wall Street Journal*, Jan. 4, 2018. <https://www.wsj.com/articles/fewer-listed-companies-is-that-good-or-bad-for-stock-markets-1515100040>

³Id.

⁴Whalen, D., Usvyatsky, O., and Tanona, D. "Audit Analytics 2017 Financial Restatements Review" <https://www.auditanalytics.com/blog/2017-financial-restatements-review/>. While the 2017 summary does not isolate reissuance restatements from total restatements, the summary does state that the decline has continued in 2017, and the prior year review noted that the number of reissuance restatements had declined from nearly 1,000 in 2006, to just over 100 in 2016 <https://www.auditanalytics.com/blog/2016-financial-restatements-review/>. As the blog notes, Reissuance Restatements address a material error that calls for the reissuance of a past financial statement. Revision Restatements generally deal with immaterial misstatements or adjustments made in the normal course of business.

⁵Cornerstone Research Securities Class Action Filings – 2018 Midyear Assessment. <https://www.cornerstone.com/Publications/Reports/Securities-Securities-Class-Action-Filings%E2%80%94Midyear-Assessment>.

⁶Id. While merger objection litigation is responsible for much of the increase in volume, there is also an increasing trend of non-accounting-related cases predicated on adverse company events. This article will focus on how the rise in event-driven litigation creates new challenges for directors and officers.

⁷Id.

⁸Coffee Jr., J. "What's Really Happening in Securities Litigation? A Tale of Two Bars." *New York Law Journal*, March 14, 2018; see also, LaCroix, K., "Turning Events into Securities Suits." *The D&O Diary*, July 17, 2017, www.dandodiary.com; Klausner, M. and Hegland, J., "Guest Post: Deeper Trends in Securities Class Actions 2006-2015." *The D&O Diary*, June 23, 2016, www.dandodiary.com.

⁹Cornerstone Research Securities Class Action Filings – 2018 Midyear Assessment, <https://www.cornerstone.com/Publications/Reports/Securities-Securities-Class-Action-Filings%E2%80%94Midyear-Assessment>.

¹⁰Coffee Jr., J. "What's Really Happening in Securities Litigation? A Tale of Two Bars." *New York Law Journal*, March 14, 2018; see also, LaCroix, K., "Turning Events into Securities Suits." *The D&O Diary*, July 17, 2017, www.dandodiary.com; Klausner, M. and Hegland, J., "Guest Post: Deeper Trends in Securities Class Actions 2006-2015." *The D&O Diary*, June 23, 2016, www.dandodiary.com.

¹¹Coffee Jr., J. "What's Really Happening in Securities Litigation? A Tale of Two Bars." *New York Law Journal*, March 14, 2018.

¹²The Report is available at: <https://www.willistowerswatson.com/en-US/insights/2018/07/2018-management-liability-d-o-us-survey>.

¹³ <https://www.sec.gov/rules/interp/2018/33-10459.pdf>

¹⁴ *Retail Wholesale & Dep't Store Union Local 338 Retirement Fund v. Hewlett-Packard Co.*, 845 F.3d 1268 (9th Cir. 2017) (dismissal affirmed); *City of Monroe Employees' Retirement System v. Ruper Murdoch*, No. 2017-0833, Del. Ch. (\$90 million Settlement approved 2/9/18); *Irving Firemen's Relief & Retirement Fund v. Signet Jewelers Ltd.*, No. 1:17-cv-02845, S.D.N.Y. (pending); *Norfolk Country Retirement System v. Stephen Wynn*, No. A-18-769062-B, Nev. Clark Cty. (pending); *In re RYB Education Sec. Litig.*, No. 1:17-cv-09261, S.D.N.Y. (alleging Chinese company knew of pervasive child abuse at its schools).

¹⁵ *In re Petrobras Sec. Litig.*, No. 1:14-cv-09662, S.D.N.Y.

¹⁶ *Id.* at Dkt. No. 834 (Opinion and Order approving settlement).

¹⁷ *Omnicare, Inc. v. Laborers Dist. Council Constr. Indus. Pension Fund*, 135 S. Ct. 1318, 1332 (2015).

¹⁸ *Matrixx Initiatives v. Siracusano*, 131 S.Ct. 1309 (2011).

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WTW-NA-2018-WTW98801

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