

Why Event-Driven Securities Class Actions Often Succeed

By **Daniel Barenbaum and Michael Dark** (April 5, 2023)

Oil spills. Train derailments. Travel meltdowns.

What these disparate catastrophes have in common is that each can give rise to a so-called event-driven securities fraud class action, a phenomenon that corporate defendants and their advocates point to as evidence that the American securities class action regime has gone haywire.

In fact, these suits illustrate precisely why securities litigation works so well to protect investors and the broader capital markets.

Understanding why these cases are frequently successful despite the stringent standards for pleading securities fraud requires a closer look at the importance of risk disclosures to market participants, and at how these cases are pleaded and proved.

Private enforcement of U.S. securities laws has been described by Harvey Goldschmid, a former commissioner at the U.S. Securities and Exchange Commission, as a "necessary supplement" to the work that the agency is charged with and a safeguard against the potential capture of the SEC by corporate interests.[1]

Notwithstanding this critical role, such cases are very difficult to bring.

The Private Securities Litigation Reform Act of 1995 imposed a heightened pleading standard on plaintiffs in these cases requiring that they plead fraud with great specificity before they have access to the discovery process available to plaintiffs in most other types of litigation.[2]

Despite these pleading hurdles, defense advocates, and even some academics, have suggested that, at least in securities fraud suits premised on fact patterns not involving accounting fraud, these cases are frivolous, an unnecessary tax on judicial resources and a waste of time for the institutional investors who frequently pursue them.[3]

But recent academic work contradicts these claims.

In a paper published in October, Duke University School of Law professor Emily Strauss undertook a review of 500 securities class actions against public companies filed between 2010 and 2015, categorizing the cases based on whether investors were the primary victims of the asserted misconduct, as is usually the case in accounting fraud, or whether the primary victims of the alleged misconduct were persons other than investors — such as "[w]hen a pharmaceutical company sells dangerously contaminated drugs, a faulty car battery bursts into flames, or an oil rig explodes" — that is, event-driven fraud cases.[4]

Her conclusions were remarkable. Strauss found that while only about 16.5% of the filed actions met her definition of event-driven litigation, these cases had significantly lower dismissal rates and generated higher settlements than cases where the primary victims were shareholders.



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She determined that investors had a 20% higher chance of dismissal if their claim primarily harmed them — as in accounting cases — and that the average shareholder settlement in cases where the misconduct most directly harms other victims is more than double the average settlement for those cases where the primary victims are shareholders.[5]

Such results are at odds with the positions of commentators decrying event-driven litigation because their analyses routinely miss two fundamental points about these cases: the importance investors attach to accurate risk disclosures and the litigation advantages that typical event-driven cases can confer on plaintiffs.

Event-driven cases typically turn not on whether a company should have been able to see a specific disaster in its future, but on misrepresentations and omissions regarding risk factors that may have led to the disaster.[6]

There are many examples of fraud cases turning on this kind of theory drawn from recent headlines.

In *Bucks County Employees Retirement System v. Norfolk Southern Corp.*, filed in the U.S. District Court for the Southern District of Ohio in March, the plaintiffs assert that Norfolk Southern failed to disclose known risks in its transportation operations that led to recent catastrophic train derailments.[7]

And in the U.S. District Court for the Southern District of Texas, the plaintiff in *Teroganessian v. Southwest Airlines Co.* claimed in January that the company failed to disclose how technological and operational issues left it vulnerable to the Christmas holiday meltdown that stranded thousands of passengers across the U.S. last year.[8]

In such securities fraud cases stemming from misleading risk disclosures, courts typically focus on whether a risk is described as merely hypothetical in a corporate securities filing when the registrant already knows that the risk is currently affecting its business.

For example, the U.S. Court of Appeals for the Ninth Circuit in *In Re: Alphabet Inc.* concluded in 2021 that a company misled investors when it merely warned of potential risk from cybersecurity issues when it had already detected serious cybersecurity problems.[9]

There is ample empirical evidence for the premise of these cases that omissions and misrepresentations regarding risk disclosures affect investment decisions.

Academics and analysts have concluded that the disclosure of risk-related information helps to minimize the information asymmetry between investors and executives regarding business risks and can help investors evaluate the future performance of the company.[10]

Securities fraud cases that deter public companies from misleading investors regarding information important to the capital markets cannot be deemed frivolous.

The other error that critics of event-driven litigation often make is not understanding why these claims can be very strong, even at the pleading stage when discovery is unavailable pursuant to the PSLRA.

First, many corporate disaster scenarios are accompanied by regulatory and legislative investigations that can provide valuable detail for fraud allegations, even in the absence of any discovery.

In the wake of Bear Stearns' March 2008 collapse, for instance, the SEC's Office of the Inspector General was asked to analyze the commission's oversight of the company. The report it issued played a key role in helping the securities class action that followed survive a motion to dismiss.[11]

Event-driven cases also offer plaintiffs investigative opportunities that do not exist in cases premised on accounting fraud.

The circle of corporate employees that might have insight into a restatement is generally limited to accountants and senior management, often posing insurmountable challenges to plaintiffs seeking to identify confidential witnesses, typically former employees, who might be able to provide evidence of corporate scienter — i.e., intent.

In a typical event-driven case, however, the disaster touches on core business practices like the maintenance of rail lines, safety issues with oil wells or the growth in unsellable inventory — all phenomena that a broad swathe of former employees may be able to shed light on.

Finally, event-driven cases can also pose fewer challenges for plaintiffs seeking to demonstrate loss causation — that is, the causal nexus between the alleged fraud and investors' losses.

In accounting cases, plaintiffs generally must undertake difficult statistical analyses to demonstrate that share price declines corresponded with the truth coming to light about accounting violations or financial results.

In a case predicated on a disaster, the loss causation theory is typically that the disaster itself, and the stock drop that follows it, is the materialization of the risks that were not disclosed to investors.

It should surprise no one that plaintiffs able to marshal such facts can benefit from that clear causal relationship.

2023 has already begun with a string of corporate disasters, and there is no indication that there is any slowdown in sight. But corporations and their advocates have no reason to fear that genuinely unforeseen events can give rise to liability.

Rather, their focus, and the focus of the investing community, should be whether bad news and key risks already known to companies but not to the public are accurately reflected in corporate filings.

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- [1] Stephen Labaton, *Businesses Seek Protection on Legal Front*, N.Y. Times (Oct. 29, 2006), <https://www.nytimes.com/2006/10/29/business/29corporate.html>.
- [2] PSLRA, Pub. L. No. 104-67, 109 Stat. 737.
- [3] See e.g. Matt Levine, *Everything Everywhere is Securities Fraud*, Bloomberg (June 26, 2019), <https://www.bloomberg.com/opinion/articles/2019-06-26/everything-everywhere-is-securities-fraud>.
- [4] Emily Strauss, *Is Everything Securities Fraud?*, 12 U.C. Irvine L. Rev. 1331, 1333 (2022), <https://scholarship.law.uci.edu/cgi/viewcontent.cgi?article=1576&context=ucilr>.
- [5] *Id.* at 1334.
- [6] Donald C. Langevoort, *Disasters and Disclosures: Securities Fraud Liability in the Shadow of Corporate Disasters*, 107 Geo. L.J. 967 (2019), https://www.law.georgetown.edu/georgetown-law-journal/wp-content/uploads/sites/26/2019/04/4Disasters-and-Disclosures_Securities-Fraud-Liability-in-the-Shadow-of-a-Corporate-Catastrophe_Langevoort.pdf.
- [7] *Complaint for Violations of the Federal Securities Laws, Bucks Cnty. Emps. Ret. Sys. v. Norfolk S. Corp.*, No. 2:23-cv-00982-MHW-KAJ (S.D. Ohio Mar. 16, 2023), ECF No. 1.
- [8] *Class Action Complaint for Violations of the Federal Securities Laws, Teroganesian v. Southwest Airlines Co., et al.*, No. 4:23-cv-00115 (S.D. Tex. Jan. 12, 2023), ECF No. 1.
- [9] *In re Alphabet, Inc. Sec. Litig.*, 1 F.4th 687, 703 (9th Cir. 2021), cert. denied sub nom. *Alphabet Inc. v. Rhode Island*, 142 S. Ct. 1227 (2022).
- [10] See, e.g. United Nations Conference on Trade & Development, *The Role of Disclosure in Risk Assessment and Enhancing the Usefulness of Corporate Reporting in Decision-Making* (Aug. 23, 2017), https://unctad.org/system/files/official-document/ciisard82_en.pdf; Jaime Caruana, *Financial Stability and Risk Disclosure* (Dec. 9, 2011) (keynote address delivered at the FSB Roundtable on Risk Disclosure, Basel), <https://www.bis.org/speeches/sp111222.htm>.
- [11] *In re: Bear Stearns Companies, Inc. Sec., Derivative, & ERISA Litig.*, 763 F. Supp. 2d 423, 447 (S.D.N.Y. 2011), on reconsideration, No. 07 CIV. 10453, 2011 WL 4072027 (S.D.N.Y. Sept. 13, 2011), and on reconsideration, No. 07 CIV. 10453, 2011 WL 4357166 (S.D.N.Y. Sept. 13, 2011).