Client Alert: The New Wave of Securities Class Action Litigation – Mismanagement of Corporate Events Can Create Vulnerability

A new age is dawning on the nature of class action securities litigation. Today, companies and their directors and officers face myriad allegations from an active plaintiffs' bar claiming corporate mismanagement following a negative event in connection with the company's operations. Commonly dubbed "event-driven" litigation, this new rendition of securities litigation results when a press worthy event happens (think, cyber breach, sexual harassment allegation, or products that cause cancer), the "Street" reacts and the company's stock price falls precipitously; finally followed by a lawsuit alleging the company should have disclosed the negative operational event earlier.

To understand this paradigm shift, we need to give history a quick review. Over the last ten to fifteen years, a significant majority of the typical securities fraud cases stemmed from a company's restatement of its past financial results. The classic case alleged the company engaged in various transactions rooted in unauthorized accounting practices with the purpose of inflating reported revenue and cash flow. Ultimately, the company was forced to restate its financial results to remedy the falsities. The stock would plunge in the face of the restatement and shareholders sued, alleging the restatement itself was an admission that the prior financial filings were materially misstated. Enter Enron and regulatory reforms aimed at deterring accounting fraud. In the years since the Enron wave of litigation settled and companies' adoption of stringent accounting practices, the number of restatements filed by public companies have steadily declined from almost one thousand in 2006 to a hundred or less in 2016 and 2017.

As the shift began, so too did a couple of other legal events and business realities. In 2016, the Delaware Chancery court in the *Trulia* decision held that Delaware would not award significant attorneys' fees in cases that resulted in a "disclosure only" settlement in merger objection cases. Nearly overnight, those cases previously filed in Delaware state courts migrated to federal court. The chart below shows the spike in merger objection case filings in federal court in late 2016 and through current day.

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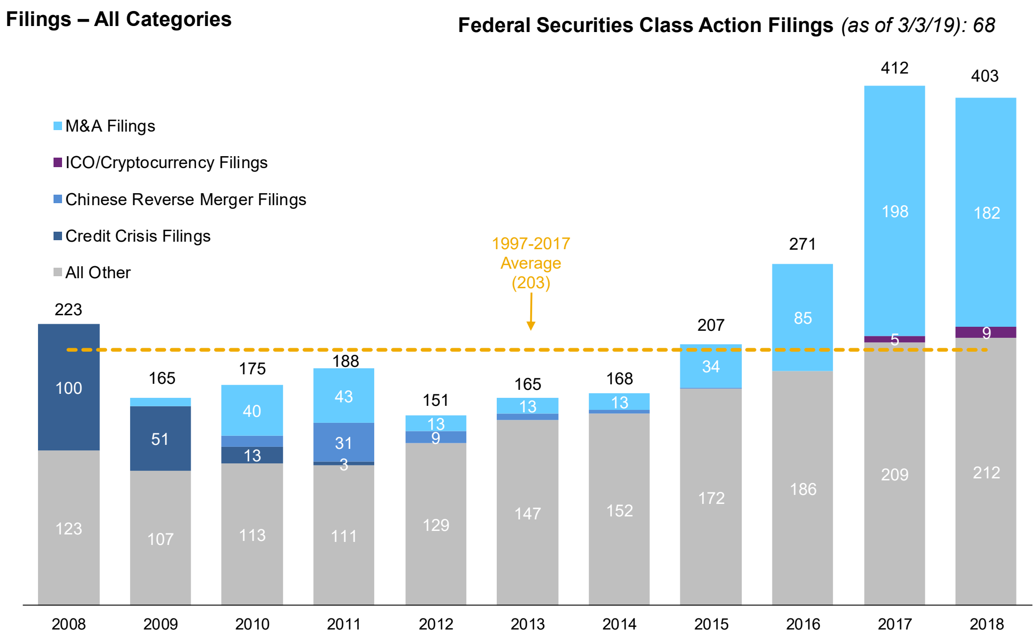
Source: Cornerstone Research - Securities Class Action Filling: 2018 Year in Review



In addition to the marked increase in the merger objection filings, the underlying consolidation of the number of public companies through these acquisitions/mergers had the obvious effect of decreasing the number of public companies. While that alone is not the only metric affecting the raw numbers, the fact is there are fewer publicly traded companies today than previously. If you consider the 403 federal securities class actions filed in 2018 (more than 200% of the average number for 1996 to 2016 [which was 193]) and the shrinking number of public companies; the fact is, public companies today have a proverbial target on their backs. At year end 2017 there were slightly more than 3,600 U.S. publicly traded companies. Juxtapose that number with the number of class action securities cases filed against publicly traded companies in 2018; nearly 8.5% of all publicly traded companies were sued in securities class actions in 2018. Notably, this is the highest rate since 2006, when the average annual litigation for 1996-2016 was 2.9%.

A common premise in the "event-driven" litigation involves mismanagement - corporate mismanagement in connection with the company's business operations. Whether the allegations relate to cyber breaches, obtaining FDA approval, a product-liability issue, a hostile corporate culture, an airplane crash, a corporate corruption scandal or a dam collapse; they almost always claim any previous statements the company made relating to the alleged operational problem were misleading for failing to disclose the event. Those statements could be, among other sources, a part of the risk factors the companies describe in their financial statements or statements made by management in public press releases, analyst or investor forums. Any statements are fair game for inclusion in an "event-driven" complaint, particularly statements following the disclosure of the event. Post event statements will be held out by plaintiffs as a presumption of mismanagement – meaning, bad news must equal bad behavior.

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Take for example, the event driven litigation emanating from claims of a toxic corporate culture - #MeToo litigation. Headliner cases across a variety of industries represent the wave of event-driven litigation stemming from news breaking scandals about sexual harassment, sexual abuse or hostile corporate culture. These cases allege securities law violations or breaches of fiduciary duty based on sexual harassment or sexual abuse allegations. The allegations are premised on the alleged failure of companies to address or disclose a systemic culture of sexual harassment or abuse by executives and other senior managers. Shareholders claim that, when the conduct was finally disclosed, they were damaged by the onslaught of lawsuits that were either avoidable to at least able to be minimized.

Other event-driven litigation has emerged from claims around corporate mismanagement of product liability exposures. A federal securities class action lawsuit against a consumer goods/pharmaceutical company charged the company with defrauding investors by failing to disclose the presence of asbestos and heavy metals in their products. The class action securities complaint followed news reports that plaintiffs who have been suing the company in cancer lawsuits have documents allegedly demonstrating that the manufacturer was aware of cancer-causing materials in their products, but failed to disclose the contamination. The lawsuit claims when news outlets began to report on the case and incriminating documents, the company's stock prices fell, damaging investors. The plaintiffs assert that "the company is responsible for the acts of the individual defendants and its employees." They charge the manufacturer with engaging in practices that "operated as a fraud or deceit" upon those who purchased company securities over a five-year class period. Health and safety incidents are also emerging as a basis for event driven litigation. Litigation arising from the California wildfires, air travel and the recent filing resulting from a dam collapse represent yet another fruitful area for event-driven follow on securities cases. In the event of the dam collapse, which resulted in floods and loss of lives, Brazilian authorities froze significant sums of the responsible party's assets to pay for the damages. The complaint alleges that throughout the class period, the responsible company and some of its senior officers made materially false and misleading statements regarding the company's business and its assessment of the risk and potential damage of a dam breach at company-owned sites, as well as the adequacy of their programs to mitigate health and safety incidents. The scope of the responsible party's misstatements has been amplified by claims in the complaint that the company made public commitments to keep its workplace safe and to minimize environmental damage following a previous dam collapse at a mine in Brazil which was joint-owned by the named responsible party. On news of the dam collapse, the price of the named company's American Depositary Receipts ("ADRs") fell, resulting in shareholder losses in billions of dollars.

Breaches of another kind – cyber – are also fertile ground for the new wave of class action securities claims arising from claims of corporate mismanagement in responses to breaches and privacy violations under the General Data Protection Regulation ("GDPR"). In one suit, the class action seeks to recover damages for alleged violations of the federal securities laws claiming that throughout the class period the company made materially false and/or misleading statements and/or failed to disclose that its end users had their personal information exposed. Further allegations include that the company actively concealed this data breach for several months, violating the company's purported data privacy and security policies. The complaint goes on to allege that the discovery of the wrongdoing could foreseeably subject the company to heightened regulatory scrutiny and that prior public statements were materially false and misleading. Following a major media outlet's article exposing the private data of hundreds of thousands of users, the company's stock fell.

Many of these "event-driven" cases also contain fact patterns where information about alleged concealment of an event was sourced from a third-party's revelation or external sources prompting shareholder litigation. Like the third party reporting in a technology firm's litigation, litigation against a global energy player illustrates yet another example of a third party's reporting of the internal corporate corruption and the news of a regulatory investigation that resulted in subsequent event-driven litigation.

A retired executive was arrested in connection with a black-market money-laundering investigation. The global energy firm never mentioned the investigation explicitly, but rather generically noted in certain financial statements over an extended period that it was merely conducting routine internal investigations into various issues. Subsequently, law enforcement authorities released sworn affidavits in which executives from the firm testified to orchestrating a long-standing kickback and bid-rigging scheme with government officials. The class action litigation quickly followed the announcement in the news. After the firm's failed attempts to dismiss the case and holding from the court in those motions finding that they misstated financials concealed the illegal kickback scheme that, when revealed, undermined the integrity of the firm. The event-driven litigation ultimately settled last year in the billions.
Regardless of the source (e.g., cyber, product liability, safety concerns, and corporate culture) of the fact patterns, the success of these event-driven class action cases will hinge on shareholders' attempts to turn corporate mismanagement into securities fraud. Shareholders will likely be challenging the principles of what legal precedent constitutes as false or misleading statement for purposes of the federal securities law. Additionally, these "event-driven" cases will be challenged with whose "scienter" (intent or knowledge of wrongdoing) can be imputed to the corporation. Shareholders will attempt to argue theories of "collective scienter" to establish that the knowledge of employees who may or may not have been involved in drafting the corporate statements should be sufficient to establish knowledge/scienter on behalf of the corporation.

It remains to be seen what the success rate will be with this new style of class action securities litigation. Regardless and rightfully so, corporations and their directors and officers will undoubtedly look to their Directors' & Officers' ("D&O") policies to back stop the cost of defending the litigation either through a successful dismissal or settlement. It is paramount that today's vintage of D&O policy has the expansive coverage offering, especially on terms that will be tested by "event-driven" litigation, such as: broad definitions of derivative demands and loss, narrow conduct exclusion and severability provisions, less ridged reporting requirements and flexibility for defense arrangements.

Aon stands prepared to empower our clients with risk advisory and risk shifting solutions to meet today's evolving securities litigation landscape and the future of director and officers' liability exposures.

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