**Securities Class Actions and Bankrupt Companies**

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*Securities class actions are criticized as wasteful suits that target temporary fluctuations in the stock prices of otherwise healthy companies. The securities class actions against Enron and Worldcom, companies that fell into bankruptcy in the wake of fraud, resulted in multi-billion dollar recoveries for permanent shareholder losses and provide a powerful counter-example to this critique. The context of bankruptcy may affect our perception of securities class actions and their merits, yet little is known about this subset of cases.*

*This is the first extensive empirical study of securities class actions involving bankrupt companies. It examines 1466 securities class actions filed from 1996 to 2004, of which 234 (16%) involved companies that were in bankruptcy proceedings while the securities class action was pending. The study tests two hypotheses. First, securities class actions involving bankrupt companies (“bankruptcy cases”) are more likely to have actual merit than securities class actions involving companies that are not in bankruptcy (“non-bankruptcy cases”) Second, bankruptcy cases are more likely to be perceived as having more merit than non-bankruptcy cases, even when they are not more meritorious.*

*The study finds stronger support for the second hypothesis than the first, suggesting that some form of hindsight bias affects the decisions of judges and parties with respect to bankruptcy cases. Even when controlling for various indicia of merit, bankruptcy cases are more likely to be successful in terms of dismissal rates, significant settlements, and third party settlements than non-bankruptcy cases. These results demonstrate that judges use heuristics not only to dismiss cases, but to avoid dismissing cases.*

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Introduction

For their critics, securities class actions create unwarranted costs for otherwise healthy companies. Lawsuits have questionable value when directed at temporary stock price drops that reflect market overreaction to short-term developments. Shareholder value will recover once the market reassesses the situation.[[2]](#footnote-2) Investors are aware that stock prices will fluctuate and can protect themselves in part through diversification.[[3]](#footnote-3) However, securities class action attorneys have significant monetary incentives to link such fluctuations to a theory of securities fraud. Significant resources must be spent in litigating the truth of the asserted fraud claim, reducing shareholder wealth.[[4]](#footnote-4)

Securities class actions directed at frauds involving large public companies that suddenly filed for bankruptcy, such as Enron and Worldcom, present a powerful counter-example to this critical account. The stock prices of these companies did not just fluctuate and recover, they precipitously and completely collapsed after revelations that financial statements were overstated by billions of dollars. Though shareholders typically are wiped out in bankruptcy, Enron and Worldcom investors recovered billions of dollars from companies that essentially were frauds through securities class actions.[[5]](#footnote-5) In the wake of Enron and Worldcom, it has become more difficult to argue that securities class actions never serve a useful purpose for shareholders.

While the Enron and Worldcom cases were obviously the focus of much attention, very little is known about the subset of securities class actions involving bankrupt companies. Many studies have examined the determinants of merit in securities class actions,[[6]](#footnote-6) but no study has examined the frequency and characteristics of bankruptcy cases. The context of bankruptcy should be interesting to scholars of securities litigation because it involves the cases involving the greatest harm to shareholders. The resolution of securities class actions involving bankrupt companies may shed light on the way in which context affects how parties and courts assess the merit of lawsuits.

There are two competing views as to the relationship between bankruptcy and securities fraud. Companies that are approaching bankruptcy may have greater incentives to commit fraud in order to save the company or the jobs of managers. On the other hand, it may also be the case that the context of bankruptcy leads parties and judges to more readily assume that fraud was present because of hindsight bias. Knowing this, class action attorneys will try to exploit this perception and bring a strike suit against the management of the bankrupt company. Bankruptcy could be a situation where defendants are at a greater risk of being unfairly portrayed as fraudsters.

 This study assesses the relationship between bankruptcy and securities fraud by analyzing a data set of 1466 consolidated class actions filed from 1996 to 2004, of which 234 (approximately 16%) cases involved a company that was in bankruptcy during the pendency of the class action (“bankruptcy cases”). The study tests two hypotheses: (1) bankruptcy cases are more likely to have actual merit than non-bankruptcy cases; and (2) bankruptcy cases are more likely to be perceived as having merit than non-bankruptcy cases, even if they do not necessarily have more merit. In doing so, it hopes to shed light upon the nature and purpose of securities class actions.[[7]](#footnote-7)

 The results of the study indicate stronger support for the second hypothesis than the first. The evidence is mixed with respect to whether bankruptcy cases are more likely to involve valid allegations of fraud than non-bankruptcy cases. While bankruptcy cases are somewhat more likely to involve accounting restatements than non-bankruptcy cases, they are not more likely to have other indicia of merit such as insider trading allegations, parallel SEC actions, or a pension fund lead plaintiff. On the other hand, bankruptcy cases are more likely to succeed than non-bankruptcy cases. Bankruptcy cases are less likely to be dismissed and are more likely to result in significant settlements and settlements by third parties than non-bankruptcy cases.

Regression analysis showed that this bankruptcy effect persists even when controlling for factors relating to the merit of the case. Logistic regressions were estimated with various measures of success as the dependent variable and various indicia or merit, case controls, and a bankruptcy variable as independent variables. For all three regressions, the bankruptcy variable was statistically significant at the 1% level.

 This bankruptcy effect is evidence that bankruptcy cases are decided differently because parties and courts assess allegations of fraud differently based on context. It is likely that some form of hindsight bias affects the decisions of judges and parties in deciding whether a bankruptcy case should be dismissed or settled for significant amounts. Bankruptcy is a heuristic judges use to avoid dismissing cases, perhaps counteracting the tendency of judges to use heuristics to dismiss securities class actions. Though the use of the bankruptcy heuristic is troubling to the extent it arbitrarily subjects bankrupt companies to greater scrutiny, a bankruptcy heuristic is not so problematic if securities class actions serve a more useful purpose than non-bankruptcy cases. Indeed, in bankruptcy cases, shareholder losses are permanent rather than temporary and compensation to shareholders for fraud is less likely to be a circular payment from shareholders to themselves.

 In addition to its main finding, that hindsight bias affects the adjudication of bankruptcy cases, the study makes a number of findings that are relevant to understanding the nature of securities class actions. The bankruptcy effect fades with respect to the largest settlements, those above $20 million, likely reflecting the influence of director and officer (D&O) insurance policy limits. Moreover, bankruptcy cases do not seem to do much to target individual defendants even when vicarious liability for the issuer is not a possibility.

 This Article is divided into four parts. Part I describes the mechanics of securities class actions in the bankruptcy context. Part II describes the data set and provides some descriptive statistics. Part III tests two hypotheses: (1) bankruptcy cases are more likely to have merit than non-bankruptcy cases; and (2) bankruptcy cases are perceived to have more merit than non-bankruptcy cases. Part IV analyzes these findings. Part V concludes.

# Background

 Securities class actions involving bankrupt companies are of interest because there is an intuitive relationship between bankruptcy and securities fraud. Managers may have greater incentive to commit fraud when a firm is heading towards bankruptcy. On the other hand, there may be a tendency to jump to unwarranted conclusions when a bankrupt company is accused of fraud even when the company is innocent. This Part discusses these two alternative accounts of the relationship between bankruptcy and securities fraud and summarizes past empirical studies on this topic. It also discusses another interesting feature of bankruptcy cases – the bankruptcy process often precludes the issuer from directly contributing to any settlement. As a result, the issuer is often dismissed from the case, leaving only individual defendants who are covered by an insurance policy and perhaps third party defendants such as underwriters and auditors.

## Bankruptcy and Securities Fraud

There are two possibilities with respect to the relationship between bankruptcy and securities fraud. First, there is an actual correlation between the context of bankruptcy and securities fraud. Second, there is no such correlation but there is a perception of such a relationship, leading to hindsight bias.

### Actual Fraud

Bankruptcy is a context where we may see a greater incidence of fraud than with respect to solvent companies. Bankruptcy could create incentives for management to commit fraud. Alternatively, managers of companies that fall into bankruptcy are more likely to commit fraud because of incompetence.

There are many reasons why a company finds itself in a position where it files for bankruptcy.[[8]](#footnote-8) Some developments leading to bankruptcy are the result of unavoidable macroeconomic trends, but others are at least partly the result of poor decisions by management who fail to make necessary investments and make bad strategic decisions. A new company may find that expected demand for its product never materializes. An established company may find that the market for its products and services shifts unexpectedly, leaving the company without enough revenue to cover its expenses. A company may overexpand, leaving it difficult to cover higher expenses such as financing costs. Overexpansion may occur because management is genuinely optimistic, but overexpansion might also be the result of reckless empire building meant to enrich the executives of the company.

The managers of a company have incentives to mask developments that foreshadow bankruptcy.[[9]](#footnote-9) Management may genuinely believe that the company’s poor performance is an aberration that is not indicative of future trends. They might fear that if disappointing results are released, the market will overreact. Instead of reporting bad results, managers can stretch ambiguous accounting standards to report results they believe are more indicative of future trends, hoping to buy some time to save the company.

On the other hand, management can be motivated by selfish personal interest rather than a genuine belief that what they are doing is best for the company. Misrepresenting the company’s performance will give managers time to exercise options or sell stock before the company’s inevitable collapse. Fraud might allow a manager to keep his job while hoping that a miracle will turn the company around.[[10]](#footnote-10) Jennifer Arlen and William Carney have identified these “last period agency costs” as a primary driver of securities fraud. [[11]](#footnote-11)

Another reason there might be a correlation between bankruptcy and securities fraud is that managers presiding over bankrupt companies are more likely to be incompetent and thus more likely to misrepresent material facts about the company. Bankruptcy may not cause fraud but the same factors that cause a company to go bankrupt can make it more likely that there is fraud in such companies. Competent managers are more likely to avoid bankruptcy and also more likely to avoid committing fraud. Thus, it could be more likely there is fraud in bankrupt companies.

### Hindsight Bias

Bankruptcy is a context where there is a significant risk of hindsight bias, the tendency to “overstate the predictability of outcomes.”[[12]](#footnote-12) Because bankruptcy is a significant and calamitous event for a public corporation, factfinders may assume that insiders with superior knowledge relative to investors must have known that bankruptcy was imminent. If that is the case, the failure to acknowledge in the company’s public disclosures the risk of the events that ultimately caused the bankruptcy will more likely be perceived as fraudulent.[[13]](#footnote-13)

To survive a motion dismiss, any securities class action complaint alleging a violation of Rule 10b-5, must “state with particularity facts giving rise to a strong inference that the defendant” acted with scienter, that is, fraudulent intent.[[14]](#footnote-14) In all circuits, this burden can be met by alleging that the defendant acted recklessly with respect to a disclosure.[[15]](#footnote-15) Recklessness has been defined by one circuit as “an extreme departure from the standards of ordinary care . . . to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.”[[16]](#footnote-16) Given the high subjective standard for liability in securities class actions, hindsight bias may not be a factor in many cases,[[17]](#footnote-17) but in a close case, hindsight bias can lead decisionmakers to conclude that in light of a company’s bankruptcy, management must have been aware of a risk that was not disclosed to investors.

The possibility of hindsight bias with respect to bankrupt companies has long been acknowledged in the accounting literature. A number of studies assessing cases against auditors (not necessarily securities class actions) find hindsight bias in the way that judges and juries assess auditor liability.[[18]](#footnote-18) In particular, the fact that an audited company filed for bankruptcy may influence the perception of an auditor’s conduct.[[19]](#footnote-19) However, there is some evidence that hindsight bias does not uniformly influence decisions, and may depend on an assessment of whether the outcome was unforeseeable.[[20]](#footnote-20)

Though auditors are typically only liable for a securities fraud if a high standard of recklessness has been met,[[21]](#footnote-21) they might be vulnerable to a finding of recklessness when an audited company falls into bankruptcy. In contrast, when a company is solvent, it is much more difficult to hold auditors liable for securities fraud. We thus might see a greater tendency to find auditors liable for fraud when the company has filed for bankruptcy.

The risk of hindsight bias may also influence the decision of defendants to settle cases for significant amounts. Baker and Griffith find through interviews of participants in the settlement process of securities class actions that D&O insurers focus on what they call “sex appeal” in assessing the amount a securities class action will be settled for.[[22]](#footnote-22) In other words, defendants themselves are subject to hindsight bias, or at least the effects of hindsight bias, in assessing the value of a claim. Bankruptcy is an obvious context that will add “sex appeal” to a case. A tendency to settle bankruptcy cases for higher amounts may also reflect the belief that judges will be affected by hindsight bias in bankruptcy cases. Either way, hindsight bias could result in a greater likelihood that settlements in bankruptcy cases will be significant.

## Mechanics of Securities Class Actions Involving Bankrupt Companies

 Regardless of the precise cause, the impact of misrepresentations relating to the performance of a company heading towards bankruptcy can be significant. If the market is fooled by the fraud, the stock price will not adequately reflect the risk that the company will go bankrupt. Investors who purchase stock at the fraudulent price will overpay by the amount the stock would have been discounted if the truth were known. Management is less likely to make necessary adjustments to their strategy without the pressure of a declining stock price. The disciplining effect of a takeover is also less likely when the stock price is inflated, possibly depriving the company of a more competent management team that could turn the situation around. Significant misstatements can result in substantial stock price declines that destabilize the company as investors lose faith in the credibility of management. As a result, a bankruptcy that might have been avoidable can become unavoidable.

 Securities class actions provide a remedy for the harm caused by misrepresentations made by a company in the period leading up to its bankruptcy. Investors can bring suit against the company, its directors and officers, as well as third party gatekeepers such as auditors and underwriters under Section 10(b) of the Securities Exchange Act,[[23]](#footnote-23) SEC Rule 10b-5,[[24]](#footnote-24) and Section 11 of the Securities Act of 1933 (if the company issued securities pursuant to a registration statement during the relevant timeframe).[[25]](#footnote-25)

 One complication with bringing a securities class action is that litigation is generally subject to the bankruptcy code’s automatic stay, which typically halts litigation against a company upon its filing for bankruptcy.[[26]](#footnote-26) Any judgment or settlement in a securities class action against a company would be an unsecured claim,[[27]](#footnote-27) and any recovery by shareholders from the bankruptcy estate would be subordinate to recovery by the company’s creditors.[[28]](#footnote-28) Though at times there are deviations from this absolute priority rule,[[29]](#footnote-29) studies find that even when shareholders receive a recovery, it is small.[[30]](#footnote-30) Reorganization plans will often discharge and release the bankrupt company from any obligation arising from the securities class action.[[31]](#footnote-31) Therefore, it is rare, though not unheard of for a bankrupt company to contribute to the settlement of a securities class action. As will be discussed below, most bankrupt issuers are not named as defendants or are later dismissed from the securities class action once the court becomes informed of the bankruptcy filing.

 However, most public companies have insurance for its directors and officers that cover the costs of securities litigation. Individual directors and officers are almost always covered by D&O insurance and many issuers often purchase D&O insurance to cover the issuer itself and to cover indemnification payments to directors and officers.[[32]](#footnote-32) Courts have generally found that payments made directly on behalf of directors and officers pursuant to D&O insurance are not part of the bankruptcy estate and are therefore not subject to the automatic stay.[[33]](#footnote-33) Indeed, such “Side A” policies appear to be specifically meant to cover situations where the issuer is bankrupt.[[34]](#footnote-34) On the other hand, D&O policies covering the company’s indemnification obligations to directors and officers have been found to be part of the bankruptcy estate.[[35]](#footnote-35) Similarly, while the courts have not definitively ruled on whether D&O insurance covering the company’s liability is part of the bankruptcy estate, commentators have argued it is likely that payments made on behalf of the issuer will be considered part of the bankruptcy estate.[[36]](#footnote-36)

 Thus, securities class actions can often proceed despite the automatic stay, but only Side A policies directly covering directors and officers can fund any litigation or settlement costs. In virtually all cases, even when a company has filed for bankruptcy, securities class actions will proceed against some if not all of the directors and officers of the corporation, and in some cases, against third parties such as underwriters and auditors, who are not covered by the automatic stay. However, because the securities class action is dismissed or stayed with respect to the bankrupt company, it is less likely that the company will directly contribute to the settlement.

## Prior Studies

Perhaps the first empirical study that examined the relationship between securities fraud and bankruptcy was a study by Arlen & Carney in 1992 where they set forth and attempted to verify their last period agency costs hypothesis. That study examined a sample of 111 reported decisions in securities class actions.[[37]](#footnote-37) In that sample, “24.3 of the firms saw the inside of bankruptcy courts. . . .”[[38]](#footnote-38) The study found some support for the last period hypothesis in that almost all of the cases involved allegations of fraud that masked stock price declines. However, a major limitation of this study was it did not have significant information on settlements, making it difficult to assess whether these cases were more likely to have valid allegations of fraud than non-bankruptcy cases.[[39]](#footnote-39)

 More recent studies looked at larger samples and have more comprehensive settlement data but have not found any link between bankruptcy and successful securities class actions. Two studies have examined in passing the effect of bankruptcy on the success of a securities class action. [[40]](#footnote-40) In a study assessing the impact of pension fund lead plaintiffs on a sample of 731 securities class action settlements, Michael A. Perino finds that bankruptcy is negatively associated with the size of securities class action settlements, meaning that bankruptcy is associated with smaller settlements.[[41]](#footnote-41) In a similar study of lead plaintiffs, Cox, Thompson, & Bai find in examining a sample of 773 securities class actions that the bankruptcy of a company does not have a statistically significant effect on the size of the settlement.[[42]](#footnote-42) These findings might be evidence that securities class actions against bankrupt companies are not likely to have more merit than securities class actions against non-bankrupt companies.

 On the other hand, as discussed earlier, the fact that a company is in bankruptcy is likely to impact the potential size of the settlement. In cases where the company is not bankrupt, it can contribute to a securities class action settlement so that the settlement amount exceeds the D&O insurance limits. When a company is bankrupt, the automatic stay would likely prevent payments that supplement those made by D&O insurance policies. Of course, third party defendants such as auditors and underwriters can contribute to the settlement, but such third party settlements can be difficult to obtain.

Class action attorneys are aware of D&O insurance limits and may take a smaller settlement in bankruptcy cases to avoid the risk that the D&O policy may be exhausted by litigation. As the Notice of Settlement for one securities class action observed:

 In this Action, there was the additional risk that even if Plaintiffs ultimately prevailed, any recovery could well be substantially less than that obtained in the proposed Settlement because of CHS' filing in bankruptcy. Under the provisions of the Bankruptcy Code, the filing means that the Action cannot proceed against the Company. Thus, any recovery obtained would be against the Individual Defendants alone and the insurance coverage available to satisfy a judgment would be greatly depleted, if not exhausted, by the costs of prosecuting the Action through trial and the subsequent appeals which would surely follow if Plaintiffs prevailed at trial.[[43]](#footnote-43)

Therefore, size of settlement may not be a good indication of the merit of the underlying suit with respect to bankruptcy cases. Understanding the relationship between securities class actions and bankruptcy requires assessing other indicators of merit.

# Data Set and Descriptive Statistics

 This Part describes the data set used in this study to analyze bankruptcy cases. The data set consists of 1466 consolidated securities class actions filed from 1996 through 2004,[[44]](#footnote-44) drawn primarily from the Stanford Securities Class Action Clearinghouse and supplemented with information from PACER, the LoPucki Bankruptcy Research Database, Westlaw, LexisNexis, and internet sources. The data set consists of traditional Rule 10b-5 and Section 11 securities class actions alleging that issuers issued misleading information about themselves in their periodic disclosures or registration statements, thus inflating their stock price. It therefore does not include securities class actions relating to fraud by research analysts, investment adviser fraud, IPO tying, mutual fund market timing, approval of a merger, and proxy fraud.[[45]](#footnote-45) Excluding such cases makes it possible to compare similar cases in assessing the influence of bankruptcy. Apart from the excluded cases, the data set contains virtually all of the securities class actions filed from 1996 to 2004.

 The data set contains 234 securities class actions involving companies that were in bankruptcy during the pendency of the securities class action. Bankruptcy cases thus make up 16% of the securities class actions in the data set. On average, from 1996 to 2004, there were 25 securities class actions per year involving bankrupt companies. Table 1 summarizes the number of bankruptcy cases filed from 1996 to 2004.

Table 1. Summary Data on Number of Bankruptcy Cases in Data Set by Year (1996-2004).

|  |  |  |  |
| --- | --- | --- | --- |
| Year | Number of Securities Class Actions  | Number of Bankruptcy Cases  | % of Securities Class Actions that were Bankruptcy Cases |
| 199619971998199920002001200220032004 | 84139198173184155186163184 | 131728263238343313 | 15.512.214.115.017.424.518.320.27.1 |
| Total | 1466 | 234 | 16.0 |

The fact of a bankruptcy filing was evident in a number of ways. A case was only classified as a bankruptcy case if there is clear evidence that the court was informed of the bankruptcy because the bankrupt company was not named as a defendant, or the bankruptcy was referenced in a pleading such as a complaint or notice of bankruptcy.[[46]](#footnote-46) In 198 of the 234 bankruptcy cases (85%), as a result of the automatic stay, the securities class action against the bankrupt company was formally dismissed or stayed, or the bankrupt company was not named in the complaint.[[47]](#footnote-47) Of the 234 bankruptcy cases, in 54 out of 234 (23%) the bankruptcy filing occurred before the filing of the complaint, and in 180 out of 234 (77%) the bankruptcy filing occurred after the filing of the complaint.[[48]](#footnote-48)

The bankrupt companies in the sample were modest in size, averaging approximately $3 billion in total assets and a median of $400 million in total assets. Non-bankrupt companies by comparison tended to be larger, averaging approximately $9 billion in total assets and a median of $3 billion in total assets.

 It appears that a substantial percentage of large public companies filing for bankruptcy face a securities class action. According to the LoPucki Bankruptcy Research Database, 448 “large” public companies filed for bankruptcy from 1996 to 2004, the period of the data set. Not all of the bankruptcy cases in the data set involved “large” companies. However, a comparison of the data set with the cases listed in the LoPucki Database found that at least 135 of 448 (30%) of the large public companies that filed for bankruptcy from 1996 to 2004 were also the subject of a securities class action.[[49]](#footnote-49) The 30% rate of suit for bankrupt companies is somewhat higher than the 24% litigation rate for bankrupt companies found in a study by J.V. Carcello and Zoe-Vonna Palmrose,[[50]](#footnote-50) and lower than the 38% litigation rate for companies restating their earnings found in a study by Zoe-Vonna Palmrose and Schulz.[[51]](#footnote-51)

 The data set also collects information on various measures such as whether a public pension fund was named as one of the lead plaintiffs, whether the securities class action included a Section 11 claim, whether the complaint alleges that the defendant restated its financial statements, whether the complaint alleges insider sales as a motivation for the fraud, and whether there were parallel SEC proceedings. These variables are relevant in assessing the merit and success of securities class actions. Table 2 presents summary statistics for some of these characteristics.

Table 2. Various Summary Statistics for Data Set (1996-2004).

|  |  |  |
| --- | --- | --- |
| Characteristic | Number of Cases | % of data set (1466 observations) |
| Pension Fund Lead PlaintiffSection 11 ClaimRestatementInsider SalesSEC Proceeding | 227301466652176 | 15.520.531.844.512.1 |

 Consistent with findings from other studies, a high percentage of the cases in the data set settled or were dismissed. 30.8% of the cases in the data set ended in dismissal.[[52]](#footnote-52) 47.7% of the cases in the data set ended in a settlement of $3 million or more. Most of these settlements involved payments by issuers or payments from their D&O insurance policy. A small percentage of settlements, 7.6%, involved payments from parties other than the issuer such as auditors, underwriters, and individual directors or officers.

Table 3. Summary of Case Results for Data Set (1996-2004).

|  |  |  |
| --- | --- | --- |
| Result | Number of Cases | % of data set (1466 observations) |
| DismissedSignificant Settlement ($3 million or more)Third Party Settlement | 452700112 | 30.847.77.6 |

# Empirical Analysis

 Using the data set just described, this Part tests two hypotheses relating to the relationship between securities fraud and bankruptcy discussed earlier. First, securities class actions against bankrupt companies are more likely to have merit than securities class actions against non-bankrupt companies. Second, securities class actions do not have more merit than securities class actions against non-bankrupt companies but are perceived as having more merit. Stronger support exists for the second hypothesis than for the first.

## Hypotheses

The first hypothesis, that there is some correlation between actual securities fraud and bankruptcy, might be framed as follows:[[53]](#footnote-53)

H(0): Bankruptcy cases are not more likely to have merit than non-bankruptcy cases.

H(A): Bankruptcy cases are more likely to have merit than non-bankruptcy cases.

The second hypothesis, which reflects a hindsight bias explanation might be framed as follows:

H(0): Bankruptcy cases are not more likely to be perceived to have merit than non-bankruptcy cases.

H(A): Bankruptcy cases are more likely to be perceived to have merit than non-bankruptcy cases.

Perhaps the most obvious way to test these hypotheses would be to compare the outcomes of bankruptcy and non-bankruptcy cases. If bankruptcy cases succeed more than non-bankruptcy cases, there is evidence supporting both the actual merit and perception of merit hypotheses.

However, looking solely at litigation results does not help decide between the actual merit and perception of merit hypotheses. To do that, one must also assess whether bankruptcy cases are more likely to allege credible evidence of fraud. Of course, it is difficult if not impossible to determine whether a complaint describes actual fraud. However, certain allegations may be more likely to objectively indicate a valid fraud claim. If bankruptcy cases are more likely to contain such indicia of merit than non-bankruptcy cases, we might conclude that they have more actual merit than non-bankruptcy cases.

##  Measures of Merit.

This Section describes the various ways this study measures the merit of securities class actions in the study’s sample. Common measures of litigation results include whether the case avoids dismissal, leads to a significant settlement, or results in a settlement from a third party. Common indicia of merit include whether the complaint alleges an accounting restatement, alleges insider sales, has a lead plaintiff that is a pension fund, and whether there is a parallel SEC proceeding.[[54]](#footnote-54)

### Litigation Results

The end-result of a securities class action is an obvious measure of merit. If a group of cases has a higher rate of successful outcomes than another group of cases, we might conclude that the first group has more merit.

 Dismissal rates are an indicator of what courts think of a subset of cases.[[55]](#footnote-55) If courts dismiss a set of cases at a high rate, it might be evidence that those cases are less likely to have merit. If the dismissal rate of a set of cases is low, it might be evidence that those cases are more likely to have merit. At the same time, dismissal rates may reflect the difficult of meeting heightened pleading requirements, prejudice by judges against certain types of cases, bad luck, or poor lawyering. Dismissal rates also do not necessarily measure what the parties themselves think of a case. A court may have imperfect information relative to the parties and come to the wrong conclusion in dismissing or not dismissing a case. Because plaintiffs do not have access to discovery until after the motion to dismiss is decided, the defendant may have information relevant to the merits of the case that is unknown to the court.

 Settlements are a rough indicator of what the parties think of a case. A defendant generally will not settle a case unless it believes that the case has some merit and that there is a risk that it will face higher costs absent a settlement. Of course, not all settlements signal a suit with merit. Parties also take into account litigation costs in negotiating a settlement. Small settlements may only indicate that the defendant is willing to pay an amount less than its litigation costs to make the suit go away.[[56]](#footnote-56) Thus, other studies tend to consider only cases where the settlement is over a certain threshold,[[57]](#footnote-57)often $3 million or more,[[58]](#footnote-58) as indicating that the settlement is significant and may reflect merit. Of course, the $3 million threshold is an imperfect measure as potential litigation costs vary among cases. A settlement of less than $3 million can be very high for some cases while a settlement of more than $3 million is low for other cases. But as a rough measure, a $3 million threshold can serve as a way of assessing the success of a securities class action.

 As discussed earlier, another way of measuring success is to compare the size of settlements. Very large settlements may indicate greater merit than smaller settlements. Absent bankruptcy, parties look at the potential damages that could result from a judgment against the defendant in assessing the amount of the settlement.[[59]](#footnote-59) But as noted before, when a company is bankrupt, insurance limits are more likely to limit the size of the settlement because the company is unlikely to contribute an amount above the policy limit. Limiting the inquiry to the fact of a significant settlement provides an objective metric that avoids the problem of comparing the size of settlements in bankruptcy and non-bankruptcy cases.

 Settlements with third parties other than the company or the company’s insurance company may also be a sign of merit. I define third party settlements to include settlements by parties unassociated with the company such as auditors and underwriters, as well as individuals associated with the company such as directors and officers when they personally contribute to the settlement. Such third party settlements are relatively rare (representing only 7.6% of the sample), reflecting the high legal standard for finding gatekeepers such as auditors and underwriters liable,[[60]](#footnote-60) and the reality that directors and officers almost never personally contribute to securities class settlements.[[61]](#footnote-61) Payments by these parties could indicate that the merits of a case are unusually strong.

 It is important to acknowledge that these measures of success are related. For example, significant settlements should result in part because parties know that certain cases are likely to survive dismissal. Certainly, third party settlements are more likely in cases involving significant settlements than in cases without significant settlements. However, each measure of success looks at the case from a different perspective. Judges decide whether to dismiss a case, issuer and management defendants decide whether there will be a significant settlement, and third party defendants decide whether a third party settlement occurs. Examining all three measures of success can allow the study to more comprehensively assess the relationship between bankruptcy and litigation results.

###  Indicia of Merit.

If a group of cases has a higher rate of common indicia of merit than another group of cases, we might conclude that the first group is more likely to have merit.

 The fact that a defendant company has restated its financial statements is widely considered to be an indicator of a securities class action’s merit.[[62]](#footnote-62) A restatement essentially concedes that there is a material misstatement in the financial statements, which the markets rely upon in valuing a company. Of course, a restatement by itself does not establish that any defendant acted with fraudulent intent,[[63]](#footnote-63) but it provides a starting point for a successful securities class action. Consistent with these intuitions, prior studies have found that restatements are associated with successful securities class actions.[[64]](#footnote-64)

 Many complaints allege that insiders were motivated to commit fraud so they could sell their stock before the stock price collapsed. Allegations of insider sales during the class period may be evidence that defendants personally profited from misleading the market, perhaps making it easier to satisfy the PSLRA requirement that the complaint plead a strong inference of scienter with particularity.[[65]](#footnote-65) On the other hand, given the frequency of insider sales, it could be that such sales were coincidental rather than part of a fraudulent scheme. Courts should be wary of concluding that an allegation of normal insider sales is in itself a good indicator of merit. At least one study has found that an allegation of insider sales does not correlate with whether a complaint survives a motion to dismiss.[[66]](#footnote-66)

 With the rising role of institutional plaintiffs such as pension funds in securities litigation, a number of commentators have posited that pension fund lead plaintiffs are associated with successful securities class actions.[[67]](#footnote-67) Pension funds are sophisticated institutions that can assess the merits of a suit and make an informed choice about whether or not to be involved. A pension fund’s choice to serve as lead plaintiff may be an additional signal that the case is persuasive. One study finds some evidence that pension funds are likely to be involved in cases with stronger evidence of securities fraud (reflecting the indicia of merit approach).[[68]](#footnote-68) A number of studies have found that pension fund lead plaintiffs are associated with higher settlements (reflecting the results approach).[[69]](#footnote-69) However, it is unclear whether settlements in these cases are higher because pension funds push for better results or because they tend to be involved in cases with merit. Either way, the presence of a pension fund lead plaintiff may be a signal that the case has characteristics of merit.

 Finally, the existence of a parallel SEC proceeding, whether it is an investigation or enforcement action, can indicate that a securities class action has merit.[[70]](#footnote-70) The fact that a government enforcer without economic incentive to overenforce the securities laws has taken action is evidence that the underlying claim has merit. In some cases, private securities class actions are filed after an SEC enforcement action has been filed. The SEC has subpoena powers allowing it to investigate allegations prior to filing a case. A securities class action can include the evidence from an SEC investigation in the complaint, making it more likely to resist a motion to dismiss.

## Tests for Association

This Section assesses whether bankruptcy cases are different from non-bankruptcy cases in light of litigation results and common indicia of merit. It does so through a simple test for association that compares bankruptcy and non-bankruptcy cases with respect to indicia of merit and litigation results. Using a 2-sided t-test, it assesses whether any difference in the rates of these variables is statistically significant. It finds that bankruptcy cases are clearly more likely to succeed in terms of litigation results, providing support for both the actual merit and perception of merit hypotheses, but the evidence is mixed with respect to whether bankruptcy cases are more likely to have indicia of merit, perhaps indicating there is stronger support for the perception of merit hypothesis.

### Litigation Results

I examined whether bankruptcy cases are more likely to be successful than non-bankruptcy cases based on whether they are less likely to be dismissed, more likely to lead to a significant settlement, and more likely to result in a third party settlement. Table A3 of the Appendix reports the results of the comparison. By all three measures, bankruptcy cases were more likely to end successfully than non-bankruptcy cases. A lower percentage of bankruptcy cases (18%) were dismissed than non-bankruptcy cases (33%). A higher percentage of bankruptcy cases (59%) resulted in significant settlements than non-bankruptcy cases (46%). A higher percentage of bankruptcy cases (24%) had third party settlements than non-bankruptcy cases (5%). All of these differences were statistically significant at the 1% confidence level. Figure 1 summarizes these results:

**Figure 1. Litigation Results.**

Judged by success, there is evidence supporting the hypotheses that bankruptcy cases are more likely to have merit or are perceived to have more merit than non-bankruptcy cases. The difference appears to be most pronounced with respect to third party settlements.

### Indicia of merit.

Table A2 of the Appendix compares rates of indicia of merit between bankruptcy and non-bankruptcy cases. There was a positive association between bankruptcy cases and restatements, though the difference was not large (39% of bankruptcy cases have an accounting restatement compared to 30% of nonbankruptcy cases). There was no statistically significant difference in the percentage of pension fund plaintiffs, and parallel SEC actions for bankruptcy cases. There was a statistically significant association between bankruptcy cases and insider sales, but the association was negative, meaning that bankruptcy cases were less likely to have allegations of insider sales that could support a scienter requirement than non-bankruptcy cases. Figure 2 summarizes these results.

**Figure 2. Indicia of Merit.**

Thus, there is some support for the hypothesis that there is a difference in actual merit between bankruptcy and non-bankruptcy cases. However, the support is not unambiguous, suggesting that the success of bankruptcy cases may reflect perception of merit rather than actual merit.

## Logistic Regression Analysis

The greater success rate of bankruptcy cases may reflect that bankruptcy cases have more merit than nonbankruptcy cases. For example, bankruptcy cases are more likely to have restatements than non-bankruptcy cases, which might translate into higher success rates. On the other hand, higher success rates may simply mean that parties perceive bankruptcy cases as having more merit even when they are not more meritorious. Comparing rates of success and indicia of merit give a rough sense of whether bankruptcy cases have more merit, but fully understanding the relationship between bankruptcy and merit requires additional analysis.

There is an obvious relationship between the success of a lawsuit and the presence of indicia of merit. A suit is more likely to succeed if it contains allegations of a restatement or involves a pension fund lead plaintiff. Judges are less likely to grant motions to dismiss if indicia of merit are present. Moreover, parties are more likely to settle cases for significant amounts, and third parties are more likely to contribute to a settlement, if indicia of merit are present.

In addition to indicia of merit, the fact that a company is bankrupt might have an effect on the success of a lawsuit. As noted earlier, the fact of bankruptcy might itself influence the decisions of judges and parties independently from the existence of objective indicia of merit.

Simple models can be constructed that test the relationship between success and indicia of merit. A bankruptcy variable can be included to test whether the fact of bankruptcy influences whether a securities class action will be successful. If the bankruptcy variable is not statistically significant, we might conclude that bankruptcy cases are generally decided the same way as non-bankruptcy cases. The higher rate of success for bankruptcy cases could reflect the higher rate of restatements we found earlier. If the bankruptcy variable is statistically significant, it may be evidence that the fact of bankruptcy has an impact apart from the higher rate of restatements found earlier.

I estimated logistic regressions[[71]](#footnote-71) with the various measures of litigation results (dismissal, significant settlements, and third party settlements) as the dependent variable and independent variables reflecting indicia of merit such as restatements, pension fund as lead plaintiff, insider sales, and parallel SEC actions. I included an independent variable reflecting whether the case is a bankruptcy case. I also included case controls such as the size of the company measured by total assets, whether the complaint alleged section 11 claims, length of class period, and circuit in which the case was filed.[[72]](#footnote-72) Variables relating to the year the case was filed as well as industry of the issuer were also included as variables though are not reported in the tables that follow. Definitions of these variables are set forth in the Appendix at Table A1.

(1) Dismissal = α + β1iBankrupcy + β2iIndicia of Merit + β3iCase Controls + εi

(2) Significant Settlement = α + β1iBankrupcy + β2iIndicia of Merit + β3iCase Controls + εi

(3) Third Party Settlement = α + β1iBankrupcy + β2iIndicia of Merit + β3iCase Controls + εi

Table 4 reports the results of the regressions. For all three regressions, the bankruptcy variable is statistically significant at the 1% confidence level. As one might predict, bankruptcy is negatively associated with dismissal and positively associated with large settlements and third party settlements. Thus, the study finds support for a “bankruptcy effect” where bankruptcy cases are more likely to succeed than non-bankruptcy cases.[[73]](#footnote-73)

In addition, as might be predicted, the restatement, pension fund as lead plaintiff, and section 11 variables were all statistically significant at the 1 or 5% confidence level for all three regressions. As might be expected, the sign of these variables was negative with respect to dismissal and positive with respect to large settlements and third party settlements.

 The insider sales variable was not statistically significant with respect to dismissal and third party settlements, but was positive and statistically significant with respect to large settlements. The lack of a statistically significant relationship between insider sales and dismissal is consistent with earlier studies.[[74]](#footnote-74) It may be that courts are not fooled by rote assertions that a securities fraud was motivated by the desire of insiders to sell their stock at a high price. With respect to third party settlements, the fact that an issuer’s management sold its stock is unlikely to affect a case against gatekeepers who did not benefit from such sales.[[75]](#footnote-75) On the other hand, the fact that insider sales are positively associated with significant settlements might indicate that the parties themselves assess such evidence in deciding whether a case has merit.

 Surprisingly, the SEC variable is not statistically significant in any of the regressions. This likely reflects the broad definition of this variable, which included not only cases that resulted in an SEC enforcement action but also cases where there was an informal investigation that may not have resulted in action.

Table 4. Logistic Regression with Dismissal, Significant Settlement, and Third Party Settlements as Dependent Variables

|  |  |  |  |
| --- | --- | --- | --- |
| Variable | Dismissal | Significant Settlement ($3 million) | Third Party Settlement |
| Log Total Assets | .113\*\*(3.64) | .198\*\*(6.62) | .030(0.54) |
| Pension Fund  | -.532\*\*(-2.68) | .635\*\*(3.41) | 1.65\*\*(5.17) |
| Second Circuit | -.288(-1.66) | .172(1.07) | .206(0.69) |
| 9th Circuit  | -.133(-0.92) | .182(1.32) | -.289(-0.93) |
| Section 11 | -.366\*(-2.32) | .725\*\*(4.95) | 1.13\*\*(4.48) |
| Bankruptcy | -.740\*\*(-3.77) | .534\*\*(3.24) | 1.92\*\*(7.57) |
| Restatement | -1.018\*\*(-6.52) | .818\*\*(6.12) | 1.49\*\*(5.84) |
| Insider Sales | -.046(-0.36) | .435\*\*(3.53) | -.220(-0.83) |
| SEC | -.198(-0.86) | .076(0.37) | .210(0.63) |
| Class Period | -.019\*\*(-3.13) | .024\*\*(4.35) | .045\*\*(4.61) |
| Constant | -2.21\*(-2.12) | -6.78\*\*(-6.31) | -6.75(-4.03) |
| Pseudo R² | 0.09 | 0.12 | 0.32 |

Note: z-statistics in parentheses. Industry and year variables not reported.

\*p<.05.

\*\*p<.01.

 Because these were logistic regressions, some translation is necessary to interpret the coefficients of the regression results. In order to quantify the bankruptcy effect, I calculated the marginal effects of selected variables. The marginal effects are a way of quantifying the impact of an independent variable such as bankruptcy on a dependent variable such as dismissal rates. For the dismissal regression, the marginal effect for the Bankruptcy variable was -0.14, meaning that a bankruptcy case was 14% less likely to end in dismissal than a Non-Bankruptcy case. As points for comparison, in the dismissal regression, the marginal effect for a Pension Fund Lead Plaintiff was -0.10 and the marginal effect for a Restatement was -0.19. For the significant settlement regression, the marginal effect for the Bankruptcy variable was 0.11, meaning that a bankruptcy case was 11% more likely to end in a significant settlement than a Non-Bankruptcy Case. The marginal effect for a Pension Fund Lead Plaintiff was 0.13 and the marginal effect for a Restatement was 0.17. For the third party settlement regression, the marginal effect for the Bankruptcy variable was .10, meaning that a bankruptcy case was 10% more likely to end in a significant settlement than a Non-Bankruptcy Case. The marginal effect for a Pension Fund Lead Plaintiff was .09 and the marginal effect for a Restatement was .08.

**Table 5. Marginal Effects of Selected Variables.**

|  |  |  |  |
| --- | --- | --- | --- |
| Litigation Result | Bankruptcy | Pension Fund Lead Plaintiff | Restatement |
| Dismissal | -0.14 | -0.10 | -0.19 |
| Significant Settlement | 0.11 | 0.13 | 0.17 |
| Third Party Settlement | .10 | .09 | .08 |

 In addition to estimating three separate logistic regressions, I also estimated an ordered logistic regression where the dependent variable was equal to 2 if the case ended in a significant settlement (more than $3 million), equal to 1 if the case ended in a settlement that was not significant (less than $3 million), and equal to 0 if the case ended in dismissal. This method takes into account the possibility that the fact of settlement, regardless of size, can be a signal of merit. The results are reproduced in the Appendix at Table A5. As with the logistic regressions, the Bankruptcy variable for the ordered logistic regression is statistically significant at the 1% level.

 By all three measures of successful securities class actions, controlling for other variables that are predictors of a successful suit, bankruptcy is associated with successful securities class actions.

## The Disappearing Bankruptcy Effect

An additional finding of this analysis is that the bankruptcy effect disappears with respect to very large settlements, providing further insight into the relationship between bankruptcy and securities class actions.

As noted earlier, a number of studies have found either no association or a negative association between the size of a settlement and the fact that a securities class action involves a bankrupt company. To verify these results, I estimated a multiple linear regression using only the cases in the data set that ended in a settlement.[[76]](#footnote-76) The dependent variable was the natural log of the size of the settlement, and the independent variables were the same as used for the earlier logistic regressions that were estimated.

(4) ln (Settlement Size) = α + β1iBankrupcy + β2iIndicia of Merit + β3iCase Controls + εi

Table A5 in the Appendix presents the results of the regression. As with the prior studies cited, the bankruptcy variable did not have a statistically significant coefficient, while other variables such as the restatement and pension fund lead plaintiff variables retained their statistical significance.

Earlier, I noted that these results may be explained by the fact that companies do not contribute to settlements when in bankruptcy. The size of settlements in bankruptcy cases are often limited by D&O policy limits. The study thus used a different measure of merit, the fact of a significant settlement, defined as those settlements of $3 million or more rather than the size of the settlement, and found a statistically significant relationship between bankruptcy and settlements of $3 million or more.

If D&O policies are affecting the size of settlements, one might expect that the bankruptcy effect will fade as settlements grow larger. Though significant in size, a $3 million settlement should fit well within the D&O policy limits of almost all public companies. I grouped settlements into different categories by size. Figure 2 summarizes the results. As can be seen from the chart, bankruptcy settlements represent a smaller proportion of the larger settlements than they do of smaller settlements.

**Figure 2. Distribution of Settlements.**

Bankruptcy cases represented about 20% of the settlements over $3 million, $15 million, and $20 million. Considering that the overall percentage of bankruptcy cases in the sample was approximately 16%, bankruptcy cases were overrepresented relative to the overall proportion of the overall data set. In contrast, bankruptcy cases represented 12-13% of the settlements over $50 million and $100 million. For the largest settlements, bankruptcy settlements were underrepresented relative to their proportion of the overall data set.

In order to further assess the point at which D&O policies affect the fact of a significant settlement, I estimated logistic regressions with higher settlement thresholds of $10 million, $15 million, $20 million, and $50 million as dependent variables. Table 6 reports the results of these regressions.

Table 6. Logistic Regressions with Settlements $10 million, $15 million, $20 million, $50 million or more as Dependent Variables

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| Variable | Settlement of $10 million or more | Settlement of $15 million or more | Settlement of $20 million or more | Settlement of $50 million or more |
| Log Total Assets | .354\*\*(9.28) | .440\*\*(9.66) | .501\*\*(9.42) | .674\*\*(7.96) |
| Pension Fund | 1.41\*\*(6.98) | 1.71\*\*(7.69) | 1.74\*\*(7.17) | 2.19\*\*(6.78) |
| Second Circuit | .316(1.66) | .438\*(2.00) | .367(1.50) | .420(1.19) |
| 9th Circuit  | .384\*(2.26) | .631\*\*(3.09) | .308(1.28) | .454(1.24) |
| Section 11 | .593\*\*(3.49) | .691\*\*(3.51) | .705\*\*(3.15) | .872\*\*(2.69) |
| Bankruptcy | .451\*(2.41) | .480\*(2.24) | .243(.97) | -.175(-.43) |
| Restatement | .855\*\*(5.41) | .677\*\*(3.61) | .941\*\*(4.43) | 1.09\*\*(3.51) |
| Insider Sales | .308\*(2.03) | .294(1.62) | .259(1.25) | .549(1.81) |
| SEC | .434(1.88) | .646\*(2.50) | .810\*\*(.282) | .957\*\*(2.57) |
| Class Period | .018\*\*(2.86) | .023\*\*(3.36) | .028\*\*(3.54) | .025\*\*(2.44) |
| Constant | -11.47(-8.21) | -13.56\*\*(-8.82) | -14.87\*\*(-8.94) | -22.24\*\*(-4.62) |
| Pseudo R² | 0.21 | .29 | .33 | .46 |

Note: z-statistics in parentheses. Industry and year variables not reported.

\*p<.05.

\*\*p<.01.

 The results show that while there is still a bankruptcy effect for settlements of $15 million or more, the bankruptcy effect disappears for larger settlements of $20 and $50 million or more. This suggests that on average, D&O policies begin affecting the size of settlements in bankruptcy cases as they reach that $20/$50 million threshold. Of course, there are still settlements in bankruptcy cases above those thresholds, but they do not occur at statistically significantly different rates compared to non-bankruptcy cases. It is likely that bankruptcy cases lose their advantage over non-bankruptcy cases with respect to settlements over $20 million or so because of the lack of an issuer defendant.

 It appears that there are two groups of settlements involving securities class actions. One set of settlements reflects payments within the limits of D&O policies. Of the 700 or so settlements in the data set greater than $3 million, about 200 are above $20 million, meaning that 500 of 700 (or 70%) of significant settlements were below $20 million and likely to fit within D&O insurance policy limits. In addition, there are many settlements below the $3 million threshold. The other set of settlements reflects a payment likely outside the limits of D&O policies. Only about 100 of the 700 settlements above $3 million, or 14%, were above $50 million, likely requiring a significant contribution by the issuer. Put another way, over the 9 year span of the data set, about 11 cases per year settle for above $50 million, representing less than 10% of all cases. Further study of settlements that do not settle within D&O insurance policy limits may be fruitful.

# Discussion

The evidence indicates that bankruptcy cases are more likely to be successful than non-bankruptcy cases. On the other hand, this greater success does not necessarily reflect greater merit. The regressions suggest that bankruptcy has an independent influence on the success of a bankruptcy case, perhaps indicating that judges and parties perceive bankruptcy cases are more likely to have merit. The bankruptcy effect provides stronger support for accepting the second hypothesis, that bankruptcy cases are perceived to have merit, than the first hypothesis, that bankruptcy cases are actually more meritorious. This result is interesting because it is an example of judges using heuristics to avoid dismissing cases. Finally, the study of bankruptcy cases may have significance for a number of issues relating to securities class actions such as the desirability of enterprise liability for securities fraud.

## Alternative Explanations for the Bankruptcy Effect

It is important to recognize that there are a number of possible explanations other than merit or perception of merit for the higher rate of success for bankruptcy cases. Companies may have fewer incentives to vigorously contest cases when they are bankrupt. A company is unlikely to cover the costs of a settlement because any obligation is typically discharged in bankruptcy. Because management is often replaced after bankruptcy,[[77]](#footnote-77) there is little incentive for the company to aggressively defend the reputation of management. Managers who are moving on from their jobs at the issuer may not have a significant incentive to fight the suit as long as a settlement is covered by D&O insurance.[[78]](#footnote-78) It can be more difficult for insurers to coordinate a defense when managers are no longer with the company. Higher rates of significant settlements for bankruptcy cases could simply reflect that it is in the best interest of the parties to settle the case rather than exhaust insurance policy limits through litigation.

On the other hand, D&O insurers, gatekeeper defendants, and directors and officers who may have to personally contribute to a settlement, have an incentive to fight a securities class action. The cost of filing a motion to dismiss is modest, and with the heightened pleading requirement, there should be an incentive to at least contest a securities class action with a motion to dismiss. A motion to dismiss is on the pleadings and needs minimal involvement from managers. Indeed, a motion to dismiss is filed in virtually every case in the data set. Because motions to dismiss are made at similar rates in bankruptcy and non-bankruptcy cases,[[79]](#footnote-79) lower dismissal rates are an indication that bankruptcy cases are more likely to have merit from the perspective of the judges deciding those motions to dismiss.

Moreover, a D&O insurer will not simply settle a case for significant sums unless there is some evidence of merit. A D&O insurer would likely fight for a nominal settlement rather than one that approaches policy limits. The greater percentage of significant settlements with respect to bankruptcy cases is thus evidence that the parties involved believe these cases are more likely to have merit. The bankruptcy effect influences settlements up to $15 million-$20 million, a substantial percentage of the typical D&O policy limit.

Finally, the higher rate of third party settlements cannot be explained solely by a lack of willingness to fight bankruptcy cases. Third parties have incentives to resist securities class actions because they may be paying out of their own pocket. On the other hand, the higher rate of significant and third party settlements may simply reflect that class action attorneys are more aggressive in seeking third party settlements in bankruptcy cases to supplement settlements limited by D&O insurance limits.

## Bankruptcy Effect: Merits or Perception?

The bankruptcy effect likely reflects some difference relating to the merits of bankruptcy cases. The question is whether the difference is an actual difference or one of perception. Bankruptcy cases may on average have more merit than non-bankruptcy cases. Alternatively, parties assessing bankruptcy cases could simply believe that bankruptcy cases have more merit. Hindsight bias might result in unwarranted findings of fraud. On the other hand, bankruptcy cases may succeed more because judges may scrutinize those cases more carefully or believe that they serve a more useful purpose than non-bankruptcy cases.

 On balance, there is some support for both possibilities, though the evidence more clearly supports the perception of merit hypothesis.

### Actual Merit

As found earlier, bankruptcy cases are somewhat more likely to be associated with accounting restatements than non-bankruptcy cases. Such difference may reflect an actual difference in merits consistent with the Arlen and Carley final period hypothesis. Bankruptcy cases are more likely to involve situations where final period agency costs are in play, leading to greater incidence of actual fraud than non-bankruptcy cases where the motivation for fraud may not be as clear. On the other hand, the difference is not a large one (39% of bankruptcy case have restatements compared to 30% of nonbankruptcy cases).

 Moreover, other indicia of merit such as allegations of insider trading, SEC proceedings, and pension fund lead plaintiffs are not present at statistically significant higher rates in bankruptcy cases. These findings should lead us to question whether bankruptcy cases truly have more merit. Some of these indicia, such as the presence of an SEC proceeding and pension fund lead plaintiff may be stronger indicators of merit than the simple existence of a restatement. Restatements can occur by mistake and a showing of fraudulent intent is usually necessary to prevail in a securities class action. The presence of a credible third party who can assess the merits of a case holistically is a stronger indicator of merit than the presence of a restatement.

 Moreover, one cannot discount the greater success rates of bankruptcy cases as an indicator of actual merit. On three different measures, dismissal rates, significant settlement rates, and third party settlement rates, bankruptcy cases are more successful than non-bankruptcy cases. Even if the higher success rates cannot be firmly linked to obvious indicators of merit, obvious indicia of merit can be imperfect indicators of whether a securities class action has merit.[[80]](#footnote-80) The higher success rates might be explained by non-obvious indicators of merit that are difficult to measure and cannot be easily scrutinized through empirical study. Such non-obvious indicators of merit could be correlated with bankruptcy and thus explain the bankruptcy effect.

The regression results, however, are evidence that actual merit alone cannot explain the tendency of bankruptcy cases to succeed at higher rates than non-bankruptcy cases. By controlling for various indicia of merit that might explain lower dismissal rates and higher rates of significant and third party settlements, the logistic regressions isolate an independent bankruptcy effect that cannot be explained solely by the actual merits.

### Perception of Merit

The bankruptcy effect is evidence that bankruptcy cases are perceived to be more meritorious than nonbankruptcy cases, regardless of the actual merit of the case. Both the parties and judges who assess whether a case has merit believe that bankruptcy cases are somehow different. Context matters with respect to the assessment of the merits. The fact of bankruptcy may be an heuristic that influences the way that judges and parties perceive the merits of bankruptcy cases, leading to higher success rates for those cases relative to non-bankruptcy cases.

On the other hand, we should not be too quick to conclude that federal judges are easily fooled by hindsight bias. Judges have long been aware of the dangers of hindsight bias and have dismissed complaints that allege no more than “fraud by hindsight.”[[81]](#footnote-81) Judges use the “fraud by hindsight” doctrine to screen out cases that do no more than allege the occurrence of some bad event in alleging fraud.[[82]](#footnote-82) Though it is unlikely that the fraud by hindsight doctrine totally solves the problem of hindsight bias,[[83]](#footnote-83) the awareness of judges raises the possibility that judges are not dismissing bankruptcy cases out of ignorance, but because in their judgment, such cases deserve closely scrutiny.

It is interesting that hindsight bias does not appear to affect the SEC and pension fund lead plaintiffs. The SEC does not appear to investigate cases involving bankrupt companies at rates greater than it investigates cases involving non-bankrupt companies. Pension fund lead plaintiffs do not appear to seek lead plaintiff status at higher rates in bankruptcy cases. On the other hand, perhaps the SEC and pension funds are more sophisticated in assessing securities fraud than generalist judges.

There is some evidence that supports the idea that the perception of merit is not solely explained by judges who jump to the conclusion that bankruptcy is an indicator of merit. The bankruptcy effect tends to be primarily associated with cases where the complaint was filed prior to the bankruptcy announcement.[[84]](#footnote-84) Judges and parties do not appear to be affected by the fact of bankruptcy when the bankruptcy filing occurs prior to the filing of the complaint. It may be that judges are wary of cases where plaintiffs appear to be exploiting the fact of bankruptcy in filing a complaint. When the bankruptcy occurs after the complaint, it is less likely that the complaint was solely motivated by the fact that the company is bankrupt. Perhaps the later bankruptcy filing provides verification with respect to certain claims that disclosures failed to adequately disclose certain risks. However, it is difficult to draw firm conclusions from smaller sub-samples of bankruptcy cases that distinguish between case filings before and after the bankruptcy.

The use of bankruptcy as a heuristic for merit is somewhat different from the judging heuristics that scholars have focused on. For the most part, heuristics have been discussed as a way by which judges can dismiss cases quickly to clear their dockets.[[85]](#footnote-85) In contrast, the use of a bankruptcy heuristic is a way that judges will allow certain cases to proceed. The bankruptcy effect counteracts the tendency of judges to dispose of securities class actions at an early stage. [[86]](#footnote-86) The existence of heuristics that make it less likely that cases will be dismissed might make it more difficult to conclude that judges always discriminate against securities class actions.

The tendency to use a bankruptcy heuristic can be problematic by leading to unjust results. It can be unfair for liability to hinge upon the happenstance that a defendant was associated with a bankrupt company.[[87]](#footnote-87) If judges are less likely to dismiss bankruptcy cases, parties may take this into account in settling a case. A bankruptcy casts suspicions on the motives of management and provides a hint of scandal that influences parties to settle for higher amounts. Defendants are especially risk averse in these situations, leading to preemptive settlements. Knowing this, plaintiffs could be more aggressive in bringing securities class actions against bankrupt companies so they can extort settlement payments.

On the other hand, the bankruptcy effect may not be as problematic if one believes there are stronger policy reasons for securities class actions when the issuer has filed for bankruptcy. The compensatory rationale for securities class actions is more compelling when a securities class action involves a bankrupt company. The loss by shareholders is likely significant and permanent rather than fleeting. Without a securities class action, shareholders typically receive little or nothing in bankruptcy.[[88]](#footnote-88)

Bankruptcy cases avoid the circularity problem that has commonly been associated with securities class action settlements involving non-bankrupt companies.[[89]](#footnote-89) As a number of commentators have noted, settlements of securities class actions involving claims of secondary market fraud are circular because injured shareholders pay for part of their own remedy.[[90]](#footnote-90) In bankruptcy, because shareholders are wiped out, any payment does not come directly from their own pockets in the form of a payment from the issuer. One source of payments is D&O insurance. Of course, shareholders do fund the costs of D&O insurance over time, but the payout to shareholders may exceed the amount in premiums paid by the shareholders. Moreover, when a company is bankrupt, there is greater incentive and ability to pursue third party wrongdoers.[[91]](#footnote-91) Rather than solely targeting the company, a securities class action may be more likely to target auditors and underwriters who stood by while the fraud proceeded.[[92]](#footnote-92) Payments by such third parties to shareholders are not circular because they do not come from the company (which is owned by the shareholders). And indeed, as this study shows, bankruptcy cases obtain third party settlements at a higher rate than non-bankruptcy cases (24% of the time versus only 5% of the time). Compensation from a successful securities class action provides shareholders with value that they would not have otherwise obtained and thus is more difficult to characterize as a meaningless transfer from shareholders to themselves.[[93]](#footnote-93)

Knowing this, perhaps judges treat bankruptcy cases differently because they believe the policy reasons are stronger for securities class actions when they involve bankrupt rather than solvent companies. Judges need not have a full appreciation for the nuances of shareholder compensation in bankruptcy but only need an intuition that the context of bankruptcy provides a better case for compensation. Judges could be dismissing these cases at lower rates because they believe that greater scrutiny of the facts through discovery is necessary to unpack the relationship between the bankruptcy and the securities fraud allegations.

## Implications

What are the implications of these findings? These findings have significance for our understanding of securities class actions.

First, the subset of securities class actions involving bankrupt companies involves a distinct context from securities class actions involving solvent companies. 16% of securities class actions involve a situation where shareholders would be wiped out without a securities class action. The argument that securities class actions needlessly harass otherwise healthy companies is much less of an issue for these cases.

Second, empirical support for the Arlen and Carney last period hypothesis is mixed. The finding that bankruptcy cases are more likely to have restatements indicate that accounting fraud may be driven by a desire to mask last period developments. On the other hand, it is evident that based on other measures, securities class actions involving non-bankrupt companies are just as likely to have indicia of merit. If these securities class actions are an accurate reflection of the incidence of securities fraud, these results indicate that securities fraud is not just a last period problem, but is also a significant problem with respect to solvent companies.

Third, it is likely that in some cases, motions to dismiss and decisions to settle are influenced by something other than the merits. Whether it is the pressure to settle in the context of a bankruptcy, or an actual hindsight bias that is affecting judges, bankruptcy cases are decided differently than non-bankruptcy cases. This might be a troubling development, and perhaps judges should be educated about these tendencies as a debiasing technique. On the other hand, to the extent that bankruptcy cases serve a more compelling policy reason, the best course may simply be to allow judges to use their discretion with respect to these cases.

## Additional Observations Relating to Vicarious Liability

This study of bankruptcy cases also has implications for the question of whether vicarious liability is desirable for securities fraud. These observations, however, are not as firmly rooted in the data and needs more study to fully develop.

In a typical securities class action, the issuer is responsible for misstatements made by individual agents. A number of commentators have suggested eliminating such vicarious liability for securities fraud on the market cases.[[94]](#footnote-94) The rationale for this proposal is that entity liability creates incentives to not target individual managers who might be responsible for the fraud. Securities fraud is arguably committed by individual managers for their own selfish reasons. Focusing securities fraud liability on these individuals could better deter securities fraud.

 Bankruptcy cases shed some light on cases where vicarious liability is not a basis for liability. As noted earlier, because the issuer is typically not a defendant, the securities class action can only proceed against managers and third parties such as auditors and underwriters. Bankruptcy cases are thus a setting where individuals should be the focus of liability rather than the company.

 In the bankruptcy cases identified in this data set, there does not appear to be additional inquiry into the responsibility of individuals for securities fraud in bankruptcy cases. Groups of directors and officers collectively settle and litigate suits and it does not appear that courts look any deeper into establishing individual liability. Though there is a smattering of cases where individuals personally contribute to the settlement, the number is an insignificant percentage of these cases. These results may indicate that vicarious liability is not the determinative factor in the lack of scrutiny of individuals in securities fraud cases. The nature of securities fraud could be such that systemic rather than individual causes are responsible. Establishing individual liability might simply be too difficult in most cases. Plaintiffs and their attorneys do not have incentives to pursue the limited assets of individual defendants.

# Conclusion

 This study began by advancing two hypotheses relating to the difference between bankruptcy and non-bankruptcy cases. The first was that there was a difference in actual merits that is consistent with the view that fraud is more likely in a last period. The second was that there was no actual difference in merits but that bankruptcy cases are perceived to have more merit than non-bankruptcy cases. Stronger support was found for the second hypothesis. Even when controlling for various indicia of merit, there is a bankruptcy effect that makes it more likely that these cases will succeed. This finding likely reflects a form of hindsight bias on the part of judges who decide these cases.

 This study has implications for understanding the role of securities class actions. Judges use heuristics not only to dismiss securities class actions but also to deny motions to dismiss. This tendency may reflect the belief that there is a core set of cases where there is greater consensus as to the utility of securities class actions. Certainly, context matters in the way that judges and parties assess the merit of securities class actions.

**Appendix:**

Table A1. Selected Variable Definitions

|  |  |
| --- | --- |
| Variable | Definition |
| Log Total Assets | Variable is equal to the natural log of the total assets of the issuer within one year prior to the filing of a securities class action.  |
| Pension Fund | Variable = 1 if the lead plaintiff is a pension fund. Variable = 0 if the lead plaintiff is not a pension fund. |
| Second Circuit | Variable = 1 if the suit was filed in a district in the U.S. Court of Appeals for the Second Circuit. Variable = 0 if the suit was not filed in a district in the U.S. Court of Appeals for the Second Circuit. |
| Ninth Circuit  | Variable = 1 if the suit was filed in a district in the U.S. Court of Appeals for the Ninth Circuit. Variable = 0 if the suit was not filed in a district in the U.S. Court of Appeals for the Ninth Circuit. |
| Section 11 | Variable = 1 if the complaint alleges a violation of section 11 of the Securities Act of 1933.Variable = 0 if the complaint does not allege a violation of section 11 of the Securities Act of 1933. |
| Bankruptcy | Variable = 1 if the issuer was in bankruptcy during the pendency of the securities class action.Variable = 0 if the issuer was not in bankruptcy during the pendency of the securities class action. |
| Restatement | Variable = 1 if the complaint alleges that the defendant issuer restated its financial statements during the class period.Variable = 0 if the complaint does not allege that the defendant issuer restated its financial statements during the class period. |
| Insider Sales | Variable = 1 if the complaint alleges that a defendant sold stock in the issuer during the class period.Variable = 0 if the complaint does not allege that a defendant sold stock in the issuer during the class period. |
| SEC | Variable = 1 if there is an SEC investigation or action relating to the subject matter of the complaint.Variable = 0 if there is not an SEC investigation or action relating to the subject matter of the complaint. |
| Class Period | Variable is equal to the length of the class period of the securities class action measured in months. |
| Dismissed | Variable = 1 if the final disposition of the case is dismissal.Variable = 0 if the final disposition of the case was not dismissal. |
| Significant Settlement | Variable = 1 if the final disposition of the case involved a settlement greater than $3 million.Variable = 0 if the final disposition of the case did not involve a settlement greater than $3 million. |
| Third Party Settlement | Variable = 1 if the final disposition of the case included a settlement by a defendant other than the issuer.Variable = 0 if the final disposition of the case did not include a settlement by a defendant other than the issuer. |

Table A2. Bankruptcy Cases and Indicia of Merit

|  |  |  |
| --- | --- | --- |
|  | **Non-Bankruptcy** | **Bankruptcy** |
| **Restatements**  |  |  |
| No Restatement | 858(70%) | 142 (61%) |
| Restatement | 374 (30%) | 92(39%) |
| Pearson χ²(1)=7.30; p=0.007. |
| **Insider Sales**  |  |  |
| No Insider Sales | 638 (52%) | 176 (75%) |
| Insider Sales | 594 (48%) | 58 (25%) |
| Pearson χ²(1)=43.71; p=0.000. |
| **SEC Proceeding** |  |  |
| No SEC | 1091(89%) | 199(85%) |
| SEC | 141(11%) | 35(15%) |
| Pearson χ²(1)=2.30; p=0.130. |
| **Pension Fund Lead Plaintiff**  |  |  |
| No Pension Fund Lead Plaintiff | 1035(84%) | 204(87%) |
| Pension Fund Lead Plaintiff | 197(16%) | 30(13%) |
| Pearson χ²(1)=1.51; p=0.219. |

Table A3. Bankruptcy Cases and Litigation Results

|  |  |  |
| --- | --- | --- |
|  | **Non-Bankruptcy** | **Bankruptcy** |
| **Dismissal**  |  |  |
| Not Dismissed | 822(67%) | 192(82%) |
| Dismissed | 410(33%) | 42(18%) |
| Pearson χ²(1)=21.67; p=0.000. |
| **Significant Settlements ($3 million or more)**  |  |  |
| No Significant Settlement  | 669(54%) | 97(41%) |
| Significant Settlement | 563(46%) | 137(59%) |
| Pearson χ²(1)=13.01; p=0.000. |
| **Third Party Settlements**  |  |  |
| No Third Party Settlement  | 1,176(95%) | 178(76%) |
| Third Party Settlement | 56(5%) | 56(24%) |
| Pearson χ²(1)=104.74; p=0.000. |

**Table A4. Ordered Logistic Regression.**

|  |  |
| --- | --- |
| Variable | Coefficient |
| Log Total Assets | .071\*\*(2.74) |
| Pension Fund | .658\*\*(3.68) |
| Second Circuit | .199(1.35) |
| 9th Circuit | .055(0.44) |
| Section 11 | .638\*\*(4.70) |
| Bankruptcy | .546\*\*(3.62) |
| Restatement | .918\*\*(7.46) |
| Insider Sales | .298\*\*(2.65) |
| SEC | .182(.99) |
| Class Period | .020\*\*(3.95) |
| Pseudo R² | .07 |

Note: z-statistics in parentheses. Industry and year variables not reported.

\*p<.05.

\*\*p<.01.

**Table A5. Multiple Linear regression with log settlement size as dependent variable.**

|  |  |
| --- | --- |
| Variable | Significant Settlement |
| Log Total Assets | .375\*\*(18.75) |
| Pension Fund | .923\*\*(7.74) |
| Second Circuit | .201(1.94) |
| 9th Circuit | .307\*\*(3.28) |
| Section 11 | .391\*\*(4.29) |
| Bankruptcy | -.041(-.41) |
| Restatement | .218\*\*(2.57) |
| Insider Sales | .323\*\*(4.00) |
| SEC | .225(1.83) |
| Class Period | .012\*\*(3.70) |
| Constant | 7.29\*\*(11.25) |
| Adjusted R² | .49 |

Note: t-statistics in parentheses. Industry and year variables not reported.

\*p<.05.

\*\*p<.01.

1. \* Associate Professor of Law, Brooklyn Law School. Thanks to Stephen Choi, Sean Griffith, Michael Perino, Amanda Rose, and participants of presentations at the 2011 Canadian Law and Economics Association, 2010 Conference on Empirical Legal Studies, Junior Business Law Scholars Conference at the University of Colorado Law School, 2011 Midwest Law and Economics Association, NYU Law School Topics in US and Global Business Regulation Seminar, and St. John’s University School of Law for helpful comments. Thanks to Kelly Kraiss, Victoria Su, and Bradley Wanner for helpful assistance in compiling the database for this study. The Brooklyn Law School Dean’s Summer Research Fund provided support for this study. [↑](#footnote-ref-1)
2. *See, e.g.*, Baruch Lev & Meiring de Villiers, *Stock Price Crashes and 10b-5 Damages: A Legal, Economic, and Policy Analysis*, 47 Stan. L. Rev. 7, 35 (1994) (“stock price crashes are short-term phenomena. . . . built-in forces, namely the informed investors’ realization that the stock price is below fundamentals, will start operating in a crash and return the price to its fundamental or equilibrium value.”). [↑](#footnote-ref-2)
3. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, *Optimal Damages in Securities Cases*, 52 U. Chi. L. Rev. 611, 641 (1985) (observing that diversified investors are protected from impact of securities fraud). [↑](#footnote-ref-3)
4. *See, e.g.*, Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlements in Securities Class Actions*, 43 Stan. L. Rev. 497, 572 (1991) (arguing that shareholder compensation shifts losses “from current to former shareholders” and “the net result is simply the destruction of shareholder value in the amount of the transaction costs of the litigation.”). [↑](#footnote-ref-4)
5. See *In re* Enron Corp. Sec. Litig., No. MDL-1446, 2008 WL 4178151 (Sept. 8, 2008) (approving $7 billion settlement fund including settlements by gatekeepers); In re Worldcom Sec. Litig., No. 02 Civ. 3288, 2005 WL 2319118 (Sept. 21, 2005) (approving $6 billion in settlements including settlements by gatekeepers). [↑](#footnote-ref-5)
6. *See* infra note 39. [↑](#footnote-ref-6)
7. There is another interesting relationship between securities class actions and bankruptcy. An empirical study by Lynn Bai, James Cox, and Randall Thomas finds evidence that companies settling securities class actions are more likely to have liquidity problems and a greater propensity to file for bankruptcy. *See* Bai, et al., *Lying and Getting Caught: An Empirical Study of the Effect of Securities Class Action Settlements on Targeted Firms*, 158 U. Penn. L. Rev. 1877 (2010). In contrast, this study focuses on the impact of bankruptcy filings prior to the resolution of securities class actions as opposed to after their resolution. [↑](#footnote-ref-7)
8. *See, e.g.*, Douglas G. Baird, *Bankruptcy’s Uncontested Axioms*, 108 Yale L.J. 573, 580-81 (1998). [↑](#footnote-ref-8)
9. *See, e.g.*, Thomas Lys & Ross L. Watts, *Lawsuits against Auditors*, 32 J. Acct. Res. 65, 68 (1994) (“We argue that managers’ incentives to mislead increase when the firm is in financial distress”). [↑](#footnote-ref-9)
10. *See, e.g.*, Jennifer H. Arlen & William J. Carney, *Vicarious Liability for Fraud on Securities Markets: Theory and Evidence*, 1992 U. Ill. L. Rev. 691, 701 (noting that managers may see benefits to fraud such as “possible preservation of employment as well as the value of the manager’s assets related to the firm’s stock, if by committing fraud he is able to buy sufficient fraud to turn the ailing firm around.”). [↑](#footnote-ref-10)
11. *See* Arlen & Carney, supra note 8, at 715 (“Under our last period hypothesis, Fraud on the Market usually results from the efforts of a few desperate managers to hide the fact that the corporation is ailing or has done sufficiently badly relative to reasonable expectations that senior managers can expect to be replace.”). [↑](#footnote-ref-11)
12. Mitu Gulati et al., *Fraud by Hindsight*, 98 Nw. U. L. Rev. 773, 778 (2004); *see also* Jeffrey J. Rachlinksi, *A Positive Psychological Theory of Judging in Hindsight*, 65 U. Chi. L. Rev. 571 (1998) (“psychologists have demonstrated repeatedly that people overstate the predictability of past events – a phenomenon that psychologists have termed ‘hindsight bias.’”). [↑](#footnote-ref-12)
13. *See, e.g.*, Zoe-Vonna Palmrose, *Litigation and Independent Auditors: The Role of Business Failures and Management Fraud*, 6 Auditing 90, 96 (1987) (“In the context of business failures, allegations usually include the assertion that business difficulties were hidden by the use or manipulation of financial information, so that either the existence or degree of financial distress was unexpected when finally disclosed.”). [↑](#footnote-ref-13)
14. Private Securities Litigation Reform Act of 1995, 15 U.S.C. § 78u-4(b)(2). [↑](#footnote-ref-14)
15. *See, e.g.*, Rothman v. Gregor, 220 F.3d 81, 90 (2d Cir. 2000) (noting that “to plead scienter . . . a complaint may . . . allege facts that constitute strong circumstantial evidence of conscious misbehavior or recklessness. . . .”); In re Silicon Graphics Inc. Sec. Litig., 183 F.3d 970, 974 (9th Cir. 1999) (finding that plaintiff must “plead, in great detail, facts that constitute strong circumstantial evidence of deliberately reckless or conscious misconduct.”). Of course, in some circuits, plaintiffs can also plead scienter by alleging motive and opportunity, Rothman v. Gregor, 220 F.3d at 90, an arguably easier standard to meet. [↑](#footnote-ref-15)
16. Rothman v. Gregor, 220 F.3d at 90 (citing Rolf v. Blyth, Eastman Dillon & Co., 570 F.2d 38, 47 (2d Cir. 1978). [↑](#footnote-ref-16)
17. *See, e.g.*, Rachlinksi, supra note 10, at 592 (“Even if subjective standards invite biased judgments, the hindsight bias probably has less influence on judgments made under subjective standards than it does on judgments made under objective standards.”). [↑](#footnote-ref-17)
18. *See, e.g.*, John C. Anderson et al., *The Mitigation of Hindsight Bias in Judges’ Evaluation of Auditor Decisions*, 16 Auditing: A Journal of Practice & Theory 20, 21 (1997) (“we established the existence of hindsight bias with judges and then attempted to mitigate it with two individual debiasing methods.”). The hindsight bias may also affect auditors who evaluate the work of other auditors. Jane Kennedy, *Debiasing the Curse of Knowledge in Audit Judgment*, 70 Acct. Rev. 249, 257 (1995) (“This experiment finds that subjects – auditors and MBA students – are susceptible to outcome knowledge that should be ignored. . . .”). [↑](#footnote-ref-18)
19. *See, e.g.*, D. Jordan Lowe & Philip M.J. Reckers, *The Effects of Hindsight Bias on Jurors’ Evaluations of Auditor Decisions*, 25 Decision Sciences 401, 417 (1994) (“In spite of receiving instructions to base their responses on information available before learning of an outcome, jurors tended to make auditor evaluation judgments in the direction of the negative (bankruptcy) outcome. Outcome knowledge of the audit client’s bankruptcy resulted in lower evaluations of the auditor’s performance.”); Thomas A. Buchman, *An Effect of Hindsight on Predicting Bankrutpcy With Accounting Information*, 10 Accounting, Organizations and Society 267, 274 (1985) (“Reporting bankruptcy increased the perceived likelihood that it would happen, as would be expected from prior research.”). [↑](#footnote-ref-19)
20. Marianne M. Jennings, et al., *Causality as an influence on hindsight bias: An empirical examination of judges’ evaluation of professional audit judgment*, 21 J. Acct. & Public Pol’y 143, 161 (1998) (“judges’ assessments of the external auditor’s responsibility to anticipate the outcome was directly related to the degree of outcome foreseeability.”). [↑](#footnote-ref-20)
21. *See, e.g.*, PR Diamonds, Inc. v. Chandler, 364 F.3d 671, 693 (2004) (“the meaning of recklessness in securities fraud cases is especially stringent when the claim is brought against an outside auditor.”); U.S. v. City of Los Angeles, 288 F.3d 385, 391 (9th Cir. 2002) (requiring allegation of “such an extreme departure from reasonable accounting practice that [the auditor] knew or had to have known that its conclusions would mislead investors.”); Rothman v. Gregor, 220 F.3d at 98 (noting that to find that an auditor acted recklessly, the conduct must “approximate an actual intent to aid in the fraud being perpetrated by the audited company.”) (citing Decker v. Massey-Ferguson, Ltd., 681 F.2d 111, 120-21 (2d Cir. 1982).

In 1994, the Supreme Court precluded a more lenient standard for holding auditors liable based on an aiding and abetting theory. *See* Central Bank v. First Interstate Bank, 511 U.S. 164 (1994) [↑](#footnote-ref-21)
22. *See, e.g.*, Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors’ and Officers’ Insurance and Securities Settlements*, 157 U. Pa. L. Rev. 755, 787 (2009). [↑](#footnote-ref-22)
23. *See* 15 U.S.C. § 78j (prohibiting manipulative and deceptive devices). [↑](#footnote-ref-23)
24. *See* 17 C.F.R. § 240.10b-5 (SEC Rule enacted pursuant to section 10(b) of the Securities Exchange Act). [↑](#footnote-ref-24)
25. *See id*. § 77k(a) (providing cause of action against issuer and other parties for misstatements in the registration statement). [↑](#footnote-ref-25)
26. 11 U.S.C. § 362. [↑](#footnote-ref-26)
27. *See, e.g.*, Notice of Proposed Settlement of Class Action, Motion for Attorneys’ Fees, and Settlement Fairness Hearing at 1, In re Eagle Building Technologies, Inc. Securities Litigation, No. 02-80294-CIV-RYSKAMP (S.D. Fl. Jan. 31, 2006) (“Bankruptcy counsel for Eagle and counsel for the Settlement Class have agreed that the Settlement Class shall have an unsecured claim of $8,000,000 in Eagle’s liquidation. However, secured and unsecured claims exceed the available proceeds for liquidation and the Settlement Class is likely to receive only a small fraction of its claim against Eagle from the bankruptcy estate.”). [↑](#footnote-ref-27)
28. Section 510(b) of the Bankruptcy Code provides:

a claim arising from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed under section 502 on account of such a claim, shall be subordinated to all claims or interests that are senior to or equal to the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock. 11 U.S.C. §510(b).

For a critique of this provision, see Kenneth B. Davis, *The Status of Defrauded Securityholders in Corporate Bankruptcy*, 1983 Duke L.J. 1. [↑](#footnote-ref-28)
29. *See, e.g.*, Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. Legal Analysis 511, 522 (2009) (finding that equity recovers only 9% of Chapter 11 cases when creditors have not been paid in full, marking a shift from recovery rates during the 1980s). [↑](#footnote-ref-29)
30. *See, e.g.*, Lynn M. LoPucki & William C. Whitford, *Bargaining Over Equity’s Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. Pa. L. Rev. 125, 143 (1990) (finding equity recoveries of between $400,000 to $63 million). [↑](#footnote-ref-30)
31. *See, e.g.*, Notice of Class Action, Proposed Settlement and Hearing Thereon at 1, In re MPower Communications Corp. Securities Litigation, No. 00-CV-6463t(b) (W.D.N.Y. Feb. 20, 2003) (“On April 8, 2002, defendant Mpower Communications Corp . (‘Mpower’ or the ‘Company’) filed a petition for relief under Chapter 11 of the Bankruptcy Code. As of the effective date of Mpower's First Amended Joint Plan of Reorganization (the ‘Plan’), Mpower was discharged and released from any claim, debt and interest, except as otherwise stated in the Plan, as set forth in the final confirmation order entered by the United States Bankruptcy Court for the District of Delaware on July 17, 2002 .”). [↑](#footnote-ref-31)
32. *See, e.g.*, Sean J. Griffith, *Uncovering a Gatekeeper: Why the SEC Should Mandate Disclosure of Details Concerning Directors’ and Officers’ Liability Insurance Policies*, 154 U. Pa. L. Rev. 1147, 1163-68 (2006). [↑](#footnote-ref-32)
33. *See, e.g.*, In re Continental Airlines, 203 F.3d 203, 216-17 (3d Cir. 2000) (implying that D&O insurance proceeds are not property of bankruptcy estate when non-debtor directors and officers are beneficiaries); In re Louisiana World Exposition, Inc., 832 F.2d 1391, 1401 (5th Cir. 1987) (finding that D&O policy proceeds belonged to the directors and officers and were not part of the estate). *But see* Amended Notice of Pendency and Proposed Settlement of Class Action at 4, In re Team Communications Group, Inc. Securities Litigation, No. 01-02312-DDP (C.D. Cal. Dec. 12, 2004) (“The Trustee opposed the previous settlement reached by the parties on the grounds that the settlement released claims belonging to Team against the Individual Defendants and others, and that the insurance proceeds designated to fund that settlement were the property of Team’s bankruptcy estate, and could not be used to fund the settlement. On September 18, 2002, the Bankruptcy Court denied a motion by one of the Insurers for relief from the Automatic Stay under 11 U.S.C §362, *inter alia*, on the grounds that the policy proceeds were the property of Team’s bankruptcy estate.”). [↑](#footnote-ref-33)
34. *See* Tom Baker & Sean J. Griffith, *The Missing Monitor in Corporate Governance: The Directors’ & Officers’ Liability Insurer*, 95 Geo. L.J. 1795, 1803 (2007) (“Side A coverage typically comes into play only when the corporation is bankrupt or insolvent.”). [↑](#footnote-ref-34)
35. *See, e.g.*, Minoco Group of Cos., Ltd. v. First State Underwriters Agency, 799 F.2d 517, 519 (9th Cir. 1986) (finding that particular D&O insurance proceeds are “property of the estate because the policies insure the corporation against indemnity claims”); In re Circle K Corp., 121 B.R. 257, 259 (Bankr. D. Ariz. 1990). [↑](#footnote-ref-35)
36. *See, e.g.*, Richard M. Ciera & Michael J. Riela, *Protecting Directors and Officers of Corporations that are Insolvent or in the Zone or Vicinity of Insolvency: Important Considerations, Practical Solutions*, 2 DePaul Bus. & Comm. L.J. 295, 333-34 (2004); Nan Roberts Eitel, *Now You Have It, Now You Don’t: Directors’ and Officers’ Insurance After a Corporate Bankruptcy*, 46 Loy. L. Rev. 585 (2000); *see also* Kelli A. Alces, *Enforcing Fiduciary Duties in Bankruptcy*, 56 Kan. L. Rev. 83, 119-125 (2007) (noting that derivative suits are controlled by the bankruptcy estate). [↑](#footnote-ref-36)
37. *See* Arlen & Carney, supra note 8, at 723. [↑](#footnote-ref-37)
38. Arlen & Carney, supra note 8, at 726. [↑](#footnote-ref-38)
39. Arlen & Carney, supra note 8, at 731 (“a sample of six firms is too small a sample from which to generalize.”). [↑](#footnote-ref-39)
40. *See, e.g.*, Janet Cooper Alexander, *Do the Merits Matter? A Study of Securities Class Actions*, 43 Stan. L. Rev. 497 (1991); James Bohn & Stephen Choi, *Fraud in the New-Issues Market: Empirical Evidence on Securities Class Actions*, 144 U. Pa. L. Rev. 903 (1996); Choi, et al., *The Screening Effect of the Private Securities Litigation Reform Act*, 6 J. Emp. L. Stud. 35 (2009); Stephen J. Choi, *Do the Merits Matter Less After the Private Securities Litigation Reform Act?*, 23 J. L. Econ. & Org. 598 (2006); Marilyn F. Johnson, et al., *Do the Merits Matter More? The Impact of the Private Securities Litigation Reform Act*, 23 J. L. Econ. & Org. 627 (2006); A.C. Pritchard & Hillary A. Sale, *What Counts as Fraud? An Empirical Study of Motions to Dismiss Under the Private Securities Litigation Reform Act*, 2 J. Emp. L. Stud. 125 (2005); *see also* Roberta Romano, *The Shareholder Suit: Litigation without Foundation?*, 7 J. L. Econ. & Org. 55 (1991) (studying merit of derivative suits). [↑](#footnote-ref-40)
41. *See* Michael A. Perino, *Institutional Activism through Litigation: An Empirical Analysis of Public Pension Fund Participation in Securities Class Actions* 23 (Oct. 2006), available at http://ssrn.com/abstract=938722. [↑](#footnote-ref-41)
42. *See* James D. Cox, et al., *There Are Plaintiffs and . . . There Are Plaintiffs: An Empirical Analysis of Securities Class Action Settlements*, 61 Vand. L. Rev. 355, 377 (2008) (“We also find that class period and bankruptcy filing are not significant explanatory variables for settlement size.”). [↑](#footnote-ref-42)
43. Notice of Pendency of Class Action, Proposed Settlement Thereof, Settlement Fairness Hearing and Right to Share in Settlement Fund at 2, In re CHS Electronics, Inc. Securities Litigation, No. 99-8186 (S.D. Fl. Nov. 29, 2001). [↑](#footnote-ref-43)
44. Typically, multiple securities class actions are filed against a company. The court will consolidate these class actions into one action and choose a lead plaintiff for the class action. [↑](#footnote-ref-44)
45. *See, e.g.*, Choi, *Do the Merits Matter Less*, supra note 38, at 605 (excluding IPO allocation cases from sample); Michael A. Perino, *Did the Private Securities Litigation Reform Act Work?*, 2003 U. Ill. L. Rev. 913, 932 (“The allegations in the [IPO] allocation cases are markedly different from the traditional securities fraud class actions.”); Arlen & Carney, supra note 8, at 722 (excluding cases involving allegations relating to mergers and hostile takeovers). [↑](#footnote-ref-45)
46. A notice of bankruptcy is a pleading filed with the court to apprise it of a defendant’s bankruptcy. [↑](#footnote-ref-46)
47. In some cases, the parties and court recognize that the bankrupt company will not contribute anything to the settlement, but the company is not formally dismissed from the case. In a small number of cases, the bankrupt company makes a contribution to the settlement that is usually minimal. [↑](#footnote-ref-47)
48. This is consistent with an earlier study that found that auditor litigation tends to precede bankruptcy. *See* J.V. Carecello, J.V. & Zoe-Vonna Palmrose, *Auditor litigation and modified reporting on bankrupt clients*, 32 J. Acct. Res. 1, 25 (1994) (“litigation following bankruptcy has the lowest occurrence rate. . . .”). [↑](#footnote-ref-48)
49. These rates may not be transferable to bankruptcies of smaller public companies. Large companies may be more susceptible generally to securities class actions. [↑](#footnote-ref-49)
50. Carecello & Palmrose, supra note 46, at 2 (studying sample of 655 public companies that declared bankruptcy between 1972 and 1992); *see also* Zoe-Vonna Palmrose, *Litigation and Independent Auditors: The Role of Business Failures and Management Fraud*, 6 Auditing 90, 96 (1987) (examining sample of 458 companies declaring bankruptcy from 1970-1985 and finding that 21% were involved in auditor litigation). [↑](#footnote-ref-50)
51. Zoe-Vonna Palmrose & Susan Scholz, *The Circumstances and Legal Consequences of Non-GAAP Reporting: Evidence from Restatements*, 21 Contemporary Acct. Res. 139 (2004). [↑](#footnote-ref-51)
52. I do not include cases that are voluntarily dismissed by the plaintiff as “dismissed” because the dismissal rate is meant to measure the assessment of the court as to the merit of the case. [↑](#footnote-ref-52)
53. H(0) designates the null hypothesis and H(A) designates the alternate hypothesis. [↑](#footnote-ref-53)
54. *See, e.g.*, Baker & Griffith, supra note 20, at 787 (“our participants frequently mentioned earnings restatements, insider selling, and SEC investigations as highly significant in determining settlement outcomes”); Choi et al., *The Screening Effect of the Private Securities Litigation Reform Act*, supra note 38, at 43 (noting that restatement or SEC investigation or enforcement action is “hard evidence” of fraud); Perino, supra note 43, at 948 (“scholars and courts often consider allegations of accounting misrepresentations or unusual trading by insiders during the class period as generally stronger, all other things being equal, than allegations that a company’s forecasts or other predictive statements were fraudulently made.”). [↑](#footnote-ref-54)
55. For an example of a study that uses dismissal rates as a measure of merit, *see* C.S. Agnes Cheng et al., *Institutional monitoring through shareholder litigation*, 95 J. Fin. Econ. 356 (2010). [↑](#footnote-ref-55)
56. *See, e.g.*, Joseph A. Grundfest, *Why Disimply*, 108 Harv. L. Rev. 727, 740-41 (1995) (“a key statistic in the merits debate is the difference between the observed settlement amount and the amount a defendant would be willing to pay simply to avoid the costs of mounting a defense.”). [↑](#footnote-ref-56)
57. *See, e.g.*, Choi, *Do the Merits Matter Less?*, supra note 38 (using $2 million threshold). [↑](#footnote-ref-57)
58. *See, e.g.*, Cox, et al., *There Are Plaintiffs*, supra note 40, at 381 (using $3 million threshold). [↑](#footnote-ref-58)
59. *See* Baker and Griffith, *How the Merits Matter*, supra note 20, at 791-96. [↑](#footnote-ref-59)
60. The Supreme Court has erected significant barriers to suits against gatekeepers. The *Central Bank* case precluded aiding and abetting liability during the period of this data set. *See* Central Bank v. First Interstate Bank, 511 U.S. 164 (1994). The impact of the Court’s decision in *Stoneridge*, which was decided 4 years after the last year of the data set, is likely limited, though some of the later cases may have been affected.  *See* Stoneridge Investment Partners v. Scientific-Atlanta, 552 U.S. 148 (2008). [↑](#footnote-ref-60)
61. *See, e.g.*, John C. Coffee, Jr., *Reforming the Securities Class Action: An Essay on Deterrence and its Implementation*, 106 Colum. L. Rev. 1534, 1551 (2006) (“The reality is that corporate insiders are sued in order for the plaintiffs to gain access to their insurance, but their personal liability appears not to be seriously pursued.”). [↑](#footnote-ref-61)
62. *See, e.g.*, Johnson et al., supra note 38, at 633-34 (“Some of the strongest evidence to satisfy [the requirement of a material misstatement] is a violation of generally accepted accounting principles (GAAP) that results in an earnings restatement, which is required only when earnings have been materially misstated.”); Stephen J. Choi et al., *Do Institutions Matter? The Impact of the Lead Plaintiff Provision of the Private Securities Litigation Reform Act*, 83 Wash. U. L. Q. 869, 892 (2005) (“we consider one measure of the pre-filing strength of the cases . . . the presence of an accounting restatement. . . .”). [↑](#footnote-ref-62)
63. Indeed, a restatement might also be an indicator that management is conscientious about acknowledging mistakes. Ideally, a distinction would be drawn between voluntary and involuntary restatements, but it can be difficult to make such a distinction. [↑](#footnote-ref-63)
64. *See, e.g.*, Perino, supra note 39; Johnson et al., supra note 38, at 646-47 (“lawsuits in the post-PSLRA period are significantly more likely to result in a settlement if the firm restated class period earnings.”). [↑](#footnote-ref-64)
65. *See* 15 U.S.C. § 78u-4(b)(2). [↑](#footnote-ref-65)
66. *See* Pritchard & Sale, supra note 38. [↑](#footnote-ref-66)
67. *See, e.g.*, Choi, et al., supra note 59; James D. Cox & Randall Thomas, with the assistance of Dana Kiku, *Does the Plaintiff Matter? An Empirical Analysis of Lead Plaintiffs in Securities Class Actions*, 106 *Colum. L. Rev.*1587 (2006); Perino, supra note 39. [↑](#footnote-ref-67)
68. *See* Choi, et al., supra note 59, at 892 (“These results . . . suggest that public pensions tended to target both larger stake cases and those with stronger evidence of fraud.”). [↑](#footnote-ref-68)
69. *See* Choi, et al., supra note 59, at 896 (“pension funds correlate with a significantly greater outcome for the class in the post-PSLRA period”); Cox and Thomas, supra note 64, at 1636 (“Our data shows that institutions increase settlements by 0.04% for every 1% increase in Provable Losses.”); Perino, supra note 39. [↑](#footnote-ref-69)
70. *See, e.g.*, Choi, et al., supra note 59, at 892 (using existence of an SEC investigation as an indicia of merit). [↑](#footnote-ref-70)
71. A logistic regression is a regression where the dependent variable is dichotomous, that is, can only take on the value of 0 or 1. [↑](#footnote-ref-71)
72. The total assets and class period variables take into account differences in potential damages awards. It is easier for a plaintiff to establish liability under section 11 because that provision does not require a showing of scienter. The circuit variables assess whether certain judges are more or less willing to allow securities class actions to proceed. [↑](#footnote-ref-72)
73. It may be that different types of bankruptcies have different associations with the measures of success. I estimated a number of logistic regressions where the Bankruptcy variable was limited in some way. For example, I estimated a regression where the Bankruptcy variable was limited to bankruptcies where the company was liquidated. I also estimated a regression where the Bankruptcy variable was limited to companies where the company was reorganized. I also distinguished between cases where the bankruptcy filing occurred prior to the filing of the complaint and cases where the bankruptcy filing occurred after the filing of the complaint. For the most part, these limited Bankruptcy variables retained their statistical significance. The exception was the limited Bankruptcy variable where the bankruptcy filing occurred prior to the filing of the complaint. [↑](#footnote-ref-73)
74. *See, e.g.*, Pritchard & Sale, supra note 38, at 146 (finding that allegations of insider trading are positively associated with dismissal and concluding that “courts are skeptical of the rather noisy signal provided by such trades.”). [↑](#footnote-ref-74)
75. Of course, insider sales might make it more likely that directors and officers are held personally liable, but directors and officers almost never personally contribute to settlements. [↑](#footnote-ref-75)
76. The average size of the settlement in all settled cases (excluding the Enron and Worldcom settlements) was approximately $40 million while the median settlement was approximately $6 million. The average size of settlement in settled cases involving a bankrupt company (excluding the Enron and Worldcom settlements) was approximately $21 million while the media settlement was approximately $7 million. The average size of settlement in settled cases involving a non-bankrupt company was approximately $44 million while the median settlement was approximately $6 million. [↑](#footnote-ref-76)
77. *See, e.g.*, M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs are Low*, 101 Nw. U. L. Rev. 1543, 1596 (2007) (finding that 60% of CEOs are replaced in the zone of insolvency); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. Pa. L. Rev. 669, 737 (1993) (finding 18 of 40 CEOs left office before or during reorganization). [↑](#footnote-ref-77)
78. There is some evidence that directors do not suffer a reputational penalty for being subjects of a securities class action. *See* Eric Helland, *Reputational Penalties and the Merits of Class-Action Securities Litigation*, 49 J. L. & Econ. 365 (2006). [↑](#footnote-ref-78)
79. Baker and Griffith find through interviews of participants in securities litigation “that defendants filed a motion to dismiss in every case with which they were familiar. . . .” Baker and Griffith, *How the Merits Matter*, supra note 20, at 775. [↑](#footnote-ref-79)
80. Choi, supra note 38. [↑](#footnote-ref-80)
81. *See, e.g.*, DiLeo v. Ernst & Young, 901 F.2d 624, 627 (1990) (applying fraud by hindsight doctrine and noting that “[b]ecause only a fraction of financial deteriorations reflects fraud, plaintiffs may not proffer the different financial statements and rest.”) (Easterbrook, J.); Denny v. Barber, 576 F.2d 465, 470 (1978) (“the complaint is an example alleging fraud by hindsight.”) (Friendly, J.). [↑](#footnote-ref-81)
82. One group of commentators describe the “fraud by hindsight” doctrine as “another way of saying that plaintiffs must have more in their complaints than just backward induction from the fact that a problem subsequently surfaced – there have to be facts showing awareness at the time of the fraud.” Gulati et al., supra note 10, at 820. [↑](#footnote-ref-82)
83. *See, e.g.*, Rachlinski, supra note 10, at 617 (“The ‘fraud by hindsight’ doctrine guards only against a severe abuse of the hindsight bias; it does not entirely purge the system of the bias’s influence.”). [↑](#footnote-ref-83)
84. As noted earlier, in 54 out of the 234 bankruptcy cases (23%) the bankruptcy filing occurred before the filing of the complaint, and in 180 out of the 234 bankruptcy cases (77%) the bankruptcy filing occurred after the filing of the complaint. I estimated regressions where the bankruptcy variable was defined as including only the cases where the bankruptcy occurred prior to the complaint. In those regressions, the bankruptcy variable was not statistically significant. On the other hand, when I estimated regressions using only the cases where the bankruptcy filing occurred after the filing of the complaint, the bankruptcy variable retained its statistical significance. [↑](#footnote-ref-84)
85. *See, e.g.*, Stephen M. Bainbridge & G. Mitu Gulati, *How do Judges Maximize? (The Same Way Everybody Else Does – Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 Emory L.J. 83, 87 (2002) (“judges are using substantive heuristics to dispose of securities cases at the motion to dismiss stage”); Hillary A. Sale, *Judging Heuristics*, 35 U.C. Davis L. Rev. 903, 946 (2002) (“courts are, consciously or unconsciously, utilizing the heuristics to clear complex cases that would otherwise remain on the dockets for lengthy periods of time.”). [↑](#footnote-ref-85)
86. Stephen Choi finds that nonnuisance claims without “hard evidence” are more likely to be dismissed post-PSLRA. Choi, supra note 38. The bankruptcy effect may be an example of one setting where the PSLRA bias towards obvious indicators of fraud is not as influential. [↑](#footnote-ref-86)
87. *See, e.g.*, Rachlinski, supra note 10, at 602 (“repeat players might notice the tendency of biased judgments to raise standards after the fact, as might judges. This could undermine the perceived fairness of the system of civil liability.”). [↑](#footnote-ref-87)
88. Shareholders only receive recovery after creditors are paid. *See* 11 U.S.C. §§ 1129(a)(8)(A); 1129(b)(2)(B)(ii). [↑](#footnote-ref-88)
89. *See, e.g.*, James J. Park, *Shareholder Compensation as Dividend*, 108 Mich. L. Rev. 323 (2009) (describing and critiquing circularity problem). [↑](#footnote-ref-89)
90. Coffee, supra note 58. Another version of the circularity problem states that because shareholders are diversified, they are as likely to be winners as losers from securities fraud. However, if a company in an investor’s portfolio goes bankrupt, the magnitude of loss is likely to be large and more difficult to offset with gains from securities fraud. Because the universe of bankrupt companies is smaller than solvent companies, it is less likely that the loss from a bankruptcy would be offset by a corresponding gain from owning stock in a bankrupt company. [↑](#footnote-ref-90)
91. As a general matter, gatekeepers are rarely named in securities class actions. *See, e.g.*, John C. Coffee, *Gatekeeper Failure and Reform: The Challenge of Fashioning Relevant Reforms*, 84 B.U. L. Rev. 301, 320 (2004). [↑](#footnote-ref-91)
92. See, e.g., Coffee, supra note 58, at 1550 (“Although large settlements involving accounting firms do occur, these often involve the insolvency of the corporate defendant (as in Enron and Worldcom) so that the auditor becomes the defendant of last resort – namely the remaining defendant with a deep pocket.”). [↑](#footnote-ref-92)
93. Bondholders may also be more likely to be plaintiffs in bankruptcy cases than non-bankruptcy cases. In the data set, 30 of 234 (13%) bankruptcy cases involved bondholder plaintiffs. When a company is solvent, it is less likely that bondholders will suffer losses than when a company is insolvent. The Worldcom case is an example where bondholders recovered billions of dollars after a bankruptcy through a securities class action. When bondholders recover compensation, such payment is not a circular transfer. The transfer is likely to come from a third party such as an underwriter or auditor or from D&O insurance that is funded by the shareholders. [↑](#footnote-ref-93)
94. *See* Arlen & Carney, supra note 8, at 720 (“We conclude that enterprise liability should not be applied to Fraud on the Market cases.”); Coffee, supra note 58 at 1582 (“The SEC can and should exempt the non-trading corporate issuer from private liability for monetary damages under Rule 10b-5.”). [↑](#footnote-ref-94)