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THOUGHT LEADERSHIP BRIEF

How Companies Can Protect Against Securities Class Action Lawsuits Using Risk Factor Disclosure

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KEY POINTS

- Securities class action lawsuits are arguably the most significant litigation risk for firms listed in the US, UK, Australia and Canada, with an average settlement of $3.4 billion USD in the US in the last decade.
- Despite managers' intention to provide information to investors by discussing forward-looking information, investors often sue companies for providing overly optimistic forecasts when the outcome is negative.
- Our research shows that managers perceive lower litigation risk in issuing forward-looking information when they disclose sufficiently detailed risk factor disclosures and invoke the safe harbor protection.
- Firms that consider listing in the United States should provide sufficient risk factor disclosure to avoid becoming targets in securities class action lawsuits.

ISSUE

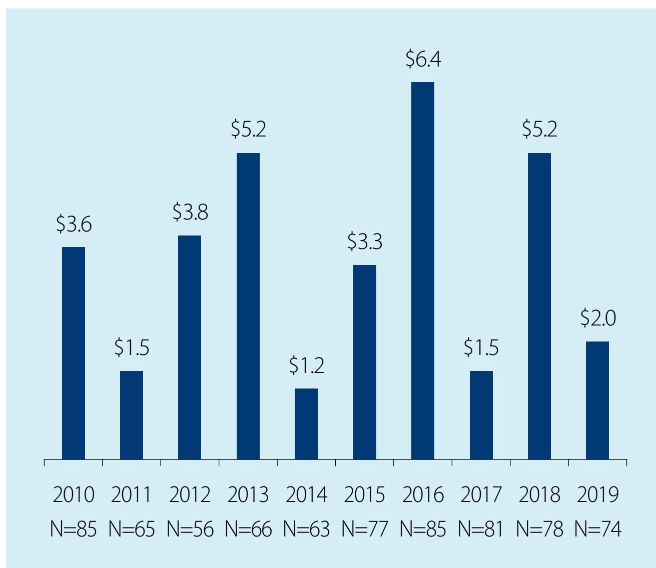
Securities class action lawsuits allow investors to recuperate investment losses caused by securities law violations. They are arguably the most significant litigation risk for firms listed in the United States and other major economics such as U.K., Australia and Canada. In these lawsuits, shareholders usually allege that company management defrauds investors by providing misleading statements or omitting material information. Many such lawsuits involve forward-looking information issued by the company such as new products, new markets and earnings guidance.

Companies issue these forward-looking statements (FLSs) to provide information to investors. However, when the outcome is negative, investors often sue companies for providing overly optimistic forecasts. According to the annual review of securities class action filings issued by a litigation consulting firm, more than half of the lawsuit filings from 2004 to 2020 involved allegations concerning misleading forward-looking statements (Cornerstone Research 2008-2020).

Since the U.S. Supreme Court's landmark ruling in Morrison v. National Australia Bank Ltd in 2010, shareholders have filed an increasing number of securities class action lawsuits against non-US companies that are listed in U.S. exchanges, with Chinese companies accounting for the largest share, e.g., Luckin Coffee. Therefore, securities class action lawsuits are becoming a more important threat for emerging market companies seeking to access capital in developed financial markets such as those in the US and U.K.

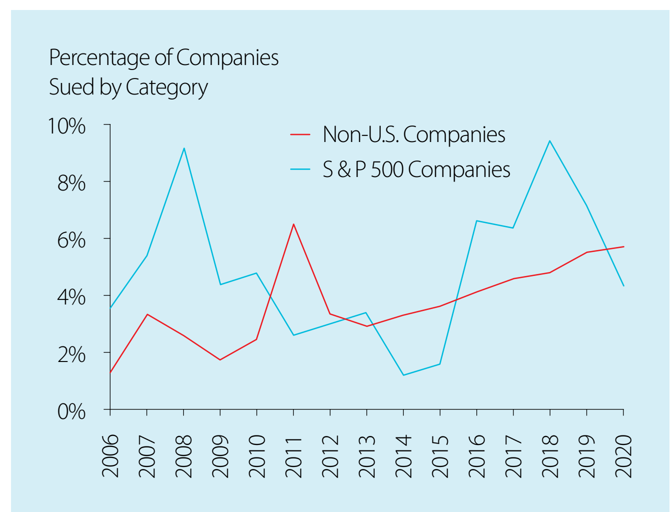
The Private Securities Litigation Reform Act (PSLRA) of 1995 provides safe harbor protection for FLSs if they are accompanied by meaningful cautionary statements identifying important factors that could cause actual results to differ materially from those in the FLSs. How do companies take advantage of the safe harbor protection to provide useful information to investors and avoid lawsuits?

Figure 1. Total Settlement Dollars. 2010-2019. (Dollars in Billions)
Note: Settlement dollars are adjusted for inflation; 2019 dollar equivalent figures are used. N refers to the number of observations.



Source: Cornerstone Research, "Securities Class Action Settlements — 2019 Review and Analysis"

Figure 2. Percentage of Companies Sued by Listing Category or Domicile — Core Federal Filings 2006-2020
Note:
1. This figure examines the incidence of non-U.S. core federal filings relative to the likelihood of S&P 500 companies being the subject of a class action.
2. Non-U.S. companies are defined as companies with headquarters outside the United States, Puerto Rico, and Virgin Islands. Companies were counted if they issue common stock or ADRs and are listed on the NYSE or Nasdaq.
3. Percentage of companies sued is calculated as the number of filings against unique companies in each category divided by the total number of companies in each category in a given year.



Source: CRSP; Yahoo Finance and Cornerstone Research, "Securities Class Action Filings — 2020 Year in Review"

ASSESSMENT

In 2005, the U.S. Securities and Exchange Commission (SEC) promulgated a risk factor (RF) regulation mandating that all firms that are publicly traded on U.S. stock exchange. publicly traded firms disclose "the most significant factors that make the company speculative or risky" in Item 1A of their 10-K filings. This regulation was intended to induce firms to provide the market with more information and greater transparency about their risk. However, court decisions and anecdotal evidence indicate that managers use RF disclosure as "meaningful cautionary language," as defined in the PSLRA of 1995, to provide safe harbor protection for FLSs. That is, although the SEC did not explicitly intend the 2005 RF mandate to provide safe harbor protection for FLSs, firms see RF disclosures as an "insurance" against litigation toward overly optimistic statements.

To examine the effect of risk factor disclosure on firms' voluntary disclosure of FLSs, we first use a rigorous difference-in-differences design to control for general trends in FLSs and gradual changes in other unobservable factors that might affect disclosure. Before the RF mandate, firms could choose not to provide risk factors for reasons such as proprietary costs, cost of capital concerns, or preparation costs. We refer to firms that only began to provide RF disclosures after the SEC's RF mandate as late RF disclosers and expect that managers of these firms will change their disclosure behavior following the RF mandate. For firms that voluntarily provided RF disclosures before the mandate, we refer to them as early RF disclosers, and use them as the control group because they provide a similar amount of RF disclosure before and after the 2005 mandate and thus are much less affected by the mandate relative to late RF disclosers.

We argue that after the mandate, managers of late RF disclosers perceive a reduction in litigation risk associated with providing FLSs, for two reasons. First, RF disclosure can lower litigation costs if the firm is sued by its shareholders. Because the mandated RF disclosures are similar to the meaningful cautionary language of the PSLRA, managers might believe that if their firm is sued by its shareholders for misleading FLSs, courts are more likely to dismiss the lawsuit because of the PSLRA's safe harbor provision. Second, RF disclosure can reduce the tendency of shareholders and their attorneys to bring lawsuits against the firm. Investors are less likely to feel wronged and entitled to financial compensation when FLSs are accompanied by cautionary disclaimers, and thus are less likely to sue the firm. Plaintiffs' attorneys, who stand to receive millions or even billions of dollars, get paid on a contingent-fee basis only. That is, they must first work hundreds or thousands of hours on a case without compensation and are only awarded attorney fees if and when they prevail in court or when the defendants agree to settle.

Intuitively, when firms are more willing to take litigation risk in providing FLSs, they disclose a larger amount of FLSs. Furthermore, because optimistic statements carry a significantly higher litigation likelihood and lead to larger shareholder damage in lawsuits than pessimistic statements do, we expect managers will provide more positive FLSs following the 2005 RF mandate.

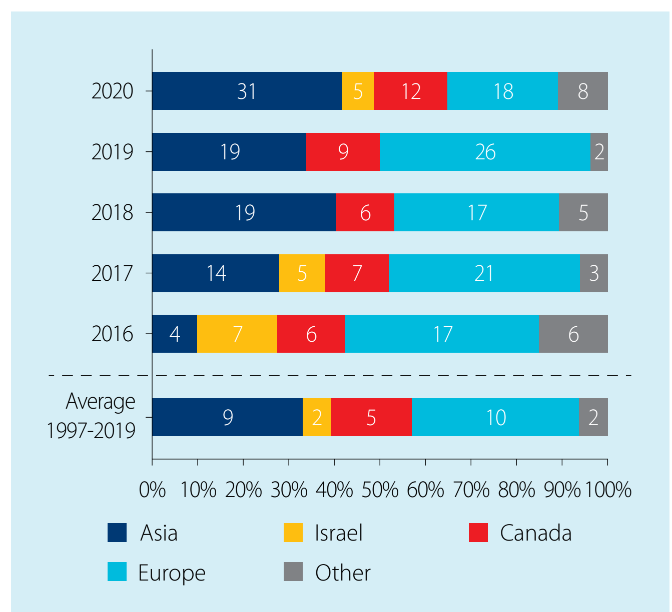
The results of our analyses suggest that the RF mandate encourages firms to take on more litigation risk in providing forward-looking information. Specifically, we find that compared to early RF disclosers, late RF disclosers provide a larger amount of FLSs in the Management's Discussion and Analysis section of their annual reports after 2005 than they did previously. The tone of their FLSs is also more optimistic, primarily due to an increase in positive FLSs rather than a decrease in negative FLSs. In addition to the diff-in-diff analysis, we use a two-stage least squares model to confirm that the RF mandate is a strong enough shock to RF disclosure to affect managers' perceived litigation risk. To examine the change in RF disclosure following the mandate, we focus on the length and specificity of RF disclosure because the PSLRA considers cautionary statements as meaningful (to invoke the safe harbor provision) only when they contain comprehensive and specific information. We find that after the mandate, late RF disclosers include a larger amount of RF disclosure and more specific RF disclosure, and that these changes explain firms' change in FLSs.

Last, even if late RF disclosers provide more positive FLSs following the mandate, it is unclear whether these additional FLSs are informative for investors. Although the SEC has long recognized the investor demand for FLSs and has encouraged and guided companies to provide such disclosure, and academic studies also document its benefits, there is concern that firms might use the safe harbor provision as a "license to lie," because it might offer protections even when managers make knowingly false projections. Managers generally have incentives to make optimistic disclosures, for example, to lower the cost of capital, cover up earnings management, or increase their own compensation. If

Figure 3. Non-U.S. Filings by Location of Headquarters — Core Federal Filings

Note:

1. The "Asia" category includes filings for companies headquartered in Hong Kong.
2. In 2020, the definition for region was changed to use groupings set by the United Nations.
3. This analysis only considers federal filings.



Source: United Nations, "Regional Groups of Member States" and Cornerstone Research, "Securities Class Action Filings — 2020 Year in Review"

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late RF disclosers perceive higher legal protection after the 2005 RF mandate, they might feel free to provide intentionally or unintentionally false FLSs. Reassuringly, we find that information environment of the late RF disclosers improves after the 2005 RF mandate, compared to that of the early RF disclosers, consistent with that managers only take advantage of the safe harbor protection afforded by the RF disclosure to disclose useful information to the market.

RECOMMENDATION / IMPLICATION

First, our research has implications for regulators by showing that regulations can have unintended consequences — that is, although regulators intend to supply investors with information about firm risk, firms prepare RF disclosures in a manner that exploits their legal benefits. This incentive leads firms to include large, seemingly boilerplate passages in their filings and prompts them to provide more forward-looking information. Regulatory consequences or the desirability of regulation is a complex issue due to the various costs and benefits that arise from regulation. Our insight cautions against drawing conclusions exclusively from the intended consequences and can help guide the development of future disclosure regulations.

Moreover, our research also has important implications for firms that are listed in stock exchanges in countries that allow securities class action lawsuits, for example, the United States. Due to investor demands, firms routinely discuss future plans such as new products, new markets, and issue earnings guidance. Despite the safe harbor provision, such disclosures remain the prime target of plaintiff complaints and lead to adverse litigation outcomes. Many firms that primarily operate in emerging markets are unfamiliar with legal regimes that allow securities class action lawsuits and ill equip to handle these lawsuits. Our recommendation is that firms that consider listing in these regimes should provide sufficient risk factor disclosure to avoid becoming targets in these lawsuits.

Reference:
"The Unintended Benefit of the Risk Factor Mandate of 2005" (Allen Huang, Jianghua Shen and Amy Zang), Review of Accounting Studies, forthcoming.

Allen Huang is Associate Professor in the Department of Accounting at the Hong Kong University of Science and Technology and Faculty Associate of HKUST IEMS. His research has been featured in CFA Digest, CFO, Harvard Business Review, Harvard Law School Forum, Vox and Financial Times, and has won First Paper in MIT Asia Conference in Accounting (twice), IRRC Institute Research Award, and International Centre for Pension Management Research Award. His publications have appeared in top-tier finance, accounting and management journals such as the Journal of Finance, Management Science, The Accounting Review, Journal of Accounting Research, Review of Accounting Studies, and Contemporary Accounting Research. He is an editor at the Journal of Business, Finance and Accounting.

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