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Resolution of restatement-induced lawsuits after the Private Securities Litigation Reform Act

Nana Y. Amoah [a,*], Alex P. Tang [b]

[a] Old Dominion University, College of Business and Public Administration, Room 2169 Constant Hall, Norfolk, VA 23529, USA
[b] Morgan State University, Graves School of Business & Management, 1700 East Cold Spring Lane, Baltimore, MD 21251, USA

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ABSTRACT

Using a sample of 185 restating firms that were sued between 1997 and 2005, we examine the role of accounting irregularity, other restatement characteristics and the Sarbanes Oxley Act in the resolution of litigation after the Private Securities Litigation Reform Act (PSLRA). The empirical results indicate that restatement due to an accounting irregularity and investigation of accounting misstatement by the Securities and Exchange Commission (SEC) are associated with a higher probability of settlement. Furthermore, the more negative the investor reaction to a restatement, the higher the probability that a lawsuit will be settled. Finally, we do not find any evidence that the Sarbanes Oxley Act is associated with the probability of a settled lawsuit. Our findings suggest that restatement-induced lawsuits with strong inference of fraud are settled in the period after the PSLRA. The results also highlight the importance of making a distinction between dismissed and settled restatement-induced lawsuits.

1. Introduction

On November 28, 2011, the rejection of the proposed \$285 million settlement of the Securities and Exchange Commission (SEC) lawsuit against Citigroup by U.S. District Judge Jed Rakoff triggered intense scrutiny and criticism of the policy of not requiring defendants in lawsuit settlements to admit or deny wrongdoing.[1] Following Judge Rakoff's rebuff of the Citigroup settlement on the premise that determination of its fairness was not possible under the policy of no admission of fraud, criticism of the policy has been widespread in the press, courts and Congress (Rieder, Huey-Burns, & Ott, 2012).

Many are of the view that the litigation process is widely abused and settlements do not necessarily reflect wrongdoing as there is no clear evidence of a link between the settled lawsuit and fraud. Further, it is argued that when a restatement centered on an unintentional misstatement results in a significant decline in the restating firm's market value, the restating firm may face a lawsuit and be coerced to settle and pay penalties.

According to Buell (2011), SEC and securities class action settlements are largely similar and do not sufficiently deter fraud as they are both characterized by a large monetary penalty and a policy of neither admission nor denial of wrongdoing. Van Rogers and Buskirk (2009) also note that there is no consensus on whether securities litigation is an effective governance mechanism.

We use a sample of 185 firms that experienced securities class actions over restatements between 1997 and 2005 to examine whether accounting irregularity and other variables are associated with the probability of settled restatement-induced lawsuit. We focus on restatement-induced litigation similar to prior studies such as Palmrose and Scholz (2004), Lev, Ryan, and Wu (2008) and Amoah and Tang (2010). We restrict our study to the period after the Private Securities Litigation Reform Act

* Corresponding author. Tel.: +757 683 3177; fax: +757 683 3258.
E-mail addresses: namoah@odu.com (N.Y. Amoah), Alex.Tang@morgan.edu (A.P. Tang).

[1] On January 6, 2012, the SEC introduced a new policy that requires admitting the SEC allegations if the defendants are found guilty of or admit to criminal conduct.

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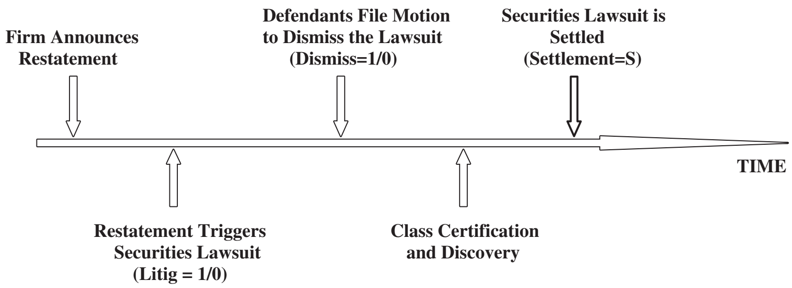

Fig. 1. Filing and resolution of securities lawsuit.

(PSLRA) as the PSLRA tightened the pleading standards for securities litigation (Grundfest & Perino, 1997; Johnson, Nelson, & Pritchard, 2007; Perino, 2002; Pritchard & Hillary A. Sale, 2003).[2] Moreover, in the post-PSLRA period, more accounting-related lawsuits are centered on restatements and inferences of fraud are expected to have a greater role in litigation resolution (Johnson et al., 2007).

We find that a restatement-induced lawsuit is more likely to be settled when the restatement is due to an accounting irregularity and there is an SEC investigation. Another result from this study is that the more negative the investor reaction around a restatement, the greater the probability of a settled lawsuit. Our study also investigates the role of the Sarbanes Oxley Act (SOX) in lawsuit settlement but we do not find any evidence of a relation between SOX and the probability of settled lawsuit.

The results of this study imply that restatement-induced lawsuits with a strong inference of fraud are more likely to be settled. Our findings highlight the importance of making a distinction between dismissed and settled restatement-induced lawsuits and it contributes to the debate on whether settled lawsuits are associated with fraud.

The rest of the paper proceeds as follows. In Section 2 we discuss the securities litigation process, related research and the hypothesis. Section 3 documents the sample selection and methodology. Section 4 describes the descriptive statistics. In Section 5 we provide the results of the analysis of settled lawsuit. Section 6 presents the summary and concluding remarks.

2. Background, related research and hypothesis

2.1. Filing and resolution of securities litigation

Typically, a restatement-induced securities lawsuit is filed by shareholders under SEC Rule 10b-5, and the restatement is cited as evidence that the firm issued materially false and misleading financial statements not in conformity with Generally Accepted Accounting Principles (GAAP).[3] As illustrated in Fig. 1, a restatement could trigger shareholder litigation. The lawsuit is filed on behalf of all persons and entities that purchased the securities of the restating firm during the class period. Defendants in the lawsuit may include the firm, CEO and other officers and directors.

Following the securities class action filing, the defendants file a motion to dismiss the lawsuit. The plaintiffs respond to the defendants' motion to dismiss and then the court rules on the motion to dismiss. Lawsuits that are not dismissed go into certification and discovery. Certification of the class action implies that the court has determined that the case is appropriate for class treatment. With the court's permission, the plaintiffs proceed to prove the allegations in the complaint using documents and testimony from the defendants and third parties. Usually, a securities lawsuit is settled after it survives a motion to dismiss but prior to or during preparation for trial. Sued firms that settle lawsuits state that they are doing so because of the high risks and costs of litigation and they deny any wrongdoing as part of the settlement agreement.

After approval of the settlement by the court, the net settlement fund (less any taxes and administration costs) is distributed to all qualified recipients according to the plan of allocation. All identified "class" members may participate in the settlement fund distribution. Excluded from the "class" are (i) the defendants, (ii) members of the immediate family of each defendant, (iii) any entity in which any defendant has a controlling interest, (iv) Officers or directors of the firm during the Class Period and (v) legal representatives, heirs or successors of all those excluded.

2.2. Accounting Irregularity and Litigation Outcome

There is some evidence in the literature of a relation between accounting irregularity and restatement-induced lawsuit. Hennes, Leone, and Miller (2008) and Amoah and Tang (2010) find a positive association between accounting irregularity and probability of restatement-induced securities lawsuit. Accounting irregularity is defined in these studies as SEC investigation, criminal charges against

[2] The Private Securities Litigation Reform Act of 1995 (PSLRA) was passed with the objective of limiting frivolous lawsuits. A key provision of PSLRA is the raising of pleading standards for securities class actions. Studies such as Spiess and Tkac, 1997, Johnson, Kasznik, and Nelson (2000), and Johnson, Nelson, and Pritchard (2000) report that the market considered the constraints on securities litigation imposed by the PSLRA to be beneficial.

[3] According to SEC Rule 10b-5, it is unlawful to materially misstate financial statements or to be involved in any act or practice that leads to fraud or deceit in the purchase or sale of any security.