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Information bundling and securities litigation

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ABSTRACT

We exploit the exogenous shock of a 2005 U.S. Supreme Court decision on securities class action loss causation requirements to examine two ways that firms bundle information with restatements: "positive bundling" of good news and "noise bundling" of additional bad news. We find that positive bundling offsets price declines and results in less litigation. In contrast, noise bundling magnifies price declines, but nevertheless deters litigation by confounding which bad news caused a decline. Non-bundled restatements are 5.94 times more likely to result in litigation. Bundled restatements have 8.17 times higher dismissal rates and $21.17 to $23.45 million lower settlement amounts.

1. Introduction

Empirical evidence suggests that some disclosure practices deter litigation (Field et al., 2005), while others prompt litigation (Francis et al., 1994; Johnson et al., 2007; Skinner, 1997). Spindler (2007) and Ferrell and Saha (2007) theorize that information bundling might reduce the costs of securities litigation. We examine whether bundling restatement announcements with other information makes it more difficult for plaintiffs to establish loss causation, a crucial element in securities class action lawsuits, thereby reducing firms' litigation costs.[1]

This question about the relationship between information bundling and securities litigation arises from two important literatures. First, managers use information bundling in various contexts. For example, managers bundle earnings forecasts and announcements (Billings et al., 2015; Rogers and Van Buskirk, 2013; Wasley and Wu, 2006), withhold bad news and bury the bad news with subsequent corporate events (Kothari et al., 2009), coordinate the timing of good and bad news releases (Lansford, 2006), and bundle positive earnings guidance with earnings announcements before selling shares (Billings and Cedergren, 2015). Graham et al., (2005) report that one third of chief financial officers admit to trying to package bad news with other disclosures.

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[1] Loss causation is the requirement that plaintiffs in a shareholder class action must show that shareholders suffered damages, and that these damages were the result of the firm's misstatements or omissions.

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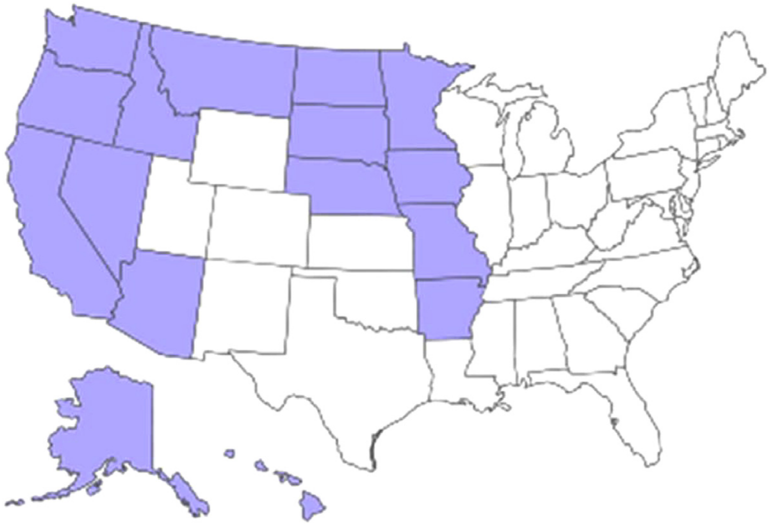

Fig. 1. Eighth and Ninth Circuits of the U.S. Courts of Appeals.
The states in the Eighth and Ninth Circuits of the U.S. Courts of Appeals are shaded on the map. The Eighth Circuit includes Arkansas, Iowa, Minnesota, Missouri, Nebraska, North Dakota, and South Dakota. The Ninth Circuit includes Alaska, Arizona, California, Hawaii, Idaho, Montana, Nevada, Oregon, and Washington. Non- shaded states belong to Circuits other than the Eighth and Ninth Circuits.

A second literature examines practices that reduce the costs of securities litigation. Skinner (1994) finds that managers voluntarily warn of bad news due to fear of legal liability. Several studies have documented that managers vary how information is disseminated to reduce litigation risk, such as accelerating the release of bad news or giving 'warnings' (Billings and Cedergren, 2015; Donelson et al., 2012; Field et al., 2005), disclosing bad news in footnotes instead of more prominent portions of disclosures (Bloomfield, 2002; Files et al., 2009; Hirshleifer and Teoh, 2003), or failing to disclose entirely (Marinovic and Varas, 2014; Rogers and Van Buskirk, 2009).[2]

We examine a specific intersection of these two literatures: the use of information bundling to reduce the costs of securities litigation by making it more difficult for shareholder plaintiffs to establish loss causation. At the outset, it is important to note litigation has both direct and indirect costs, including significant declines in the firm's stock price (Bhattacharya et al., 2007; Gande and Lewis, 2009), attorney fees, managerial time and focus, reputational costs (Karpoff and Lott, 1993; Karpoff et al., 2008), and the potential to erode managers' information advantage over shareholders as information becomes available when a lawsuit proceeds beyond the early stages (Haslem, 2005). The direct costs of settlement values alone are substantial: billions in aggregate per year (Zingales, 2007). Furthermore, managers often face increased discipline from takeovers, reduced pay, and potential loss of employment after litigation (Humphrey-Jenner, 2012).

Loss causation is a particularly important element in securities litigation. According to the courts, loss causation is established in three parts: "(1) identifying a 'corrective disclosure' (a release of information that reveals to the market the pertinent truth that was previously concealed or obscured by the company's fraud); (2) showing that the stock price dropped soon after the corrective disclosure; and (3) eliminating other possible explanations for this price drop, so that the fact finder can infer that it is more probable than not that it was the corrective disclosure—as opposed to other possible depressive factors—that caused at least a 'substantial' amount of the price drop" (*FindWhat Investor Group v. Findwhat.com*, 658 F.3d 1282, 1311–12 (11th Cir. 2011)).

Before the 2005 U.S. Supreme Court ruling in *Dura Pharmaceuticals v. Broudo*, courts in the Eighth and Ninth Circuits (see Figure 1), permitted plaintiffs to establish loss causation merely by alleging that a firm's stock price was inflated at the time of the alleged misstatements or omissions. Other courts, outside the Eighth and Ninth Circuits, disagreed and ruled that a claim of price inflation was insufficient to establish loss causation. Instead, those courts required that plaintiffs must meet higher standards of pleading and proof by establishing a connection between a "corrective disclosure" and a contemporaneous stock price decline. The *Dura* ruling effectively raised the standard for the Eighth and Ninth Circuits to the same level that other courts previously imposed.

We examine how a firm's release of information can influence the likelihood and cost of litigation, both by impacting the stock price decline and by confounding the facts about what caused that decline. Specifically, we focus on two distinct types of information bundling. First, we examine "positive bundling," a disclosure practice that adds good news to bad news. Thaler (1985) labels this the "silver lining" approach. The release of contemporaneous good news can positively

[2] Other studies show how firms alter the release of bad news such as disclosing after-market hours (deHaan, et al., 2015; Patell and Wolfson, 1982), and adding complexity to financial statements to obfuscate poor performance (Li, 2008).