Professional Liability Litigation
FROM THE SECTION OF LITIGATION PROFESSIONAL LIABILITY LITIGATION COMMITTEE

What Makes Securities Class Actions with Accounting Allegations Different?

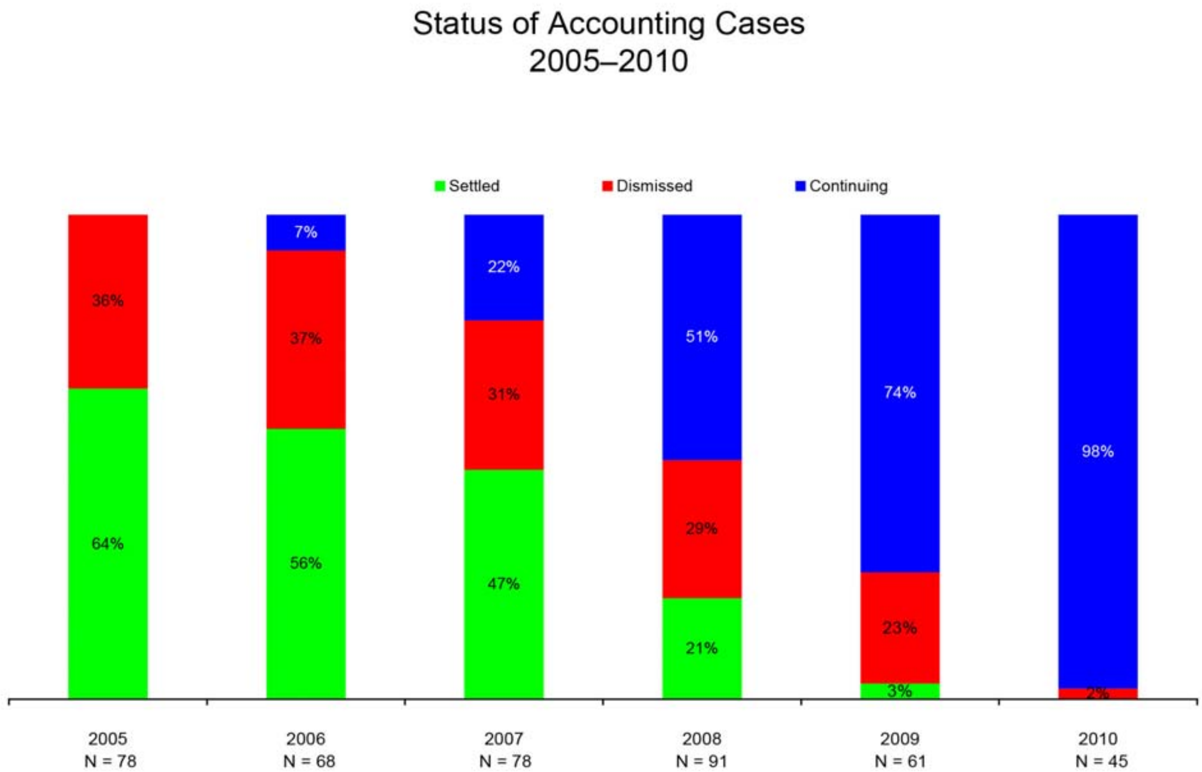
By Elaine Harwood, Adoria Lim, and Laura Simmons

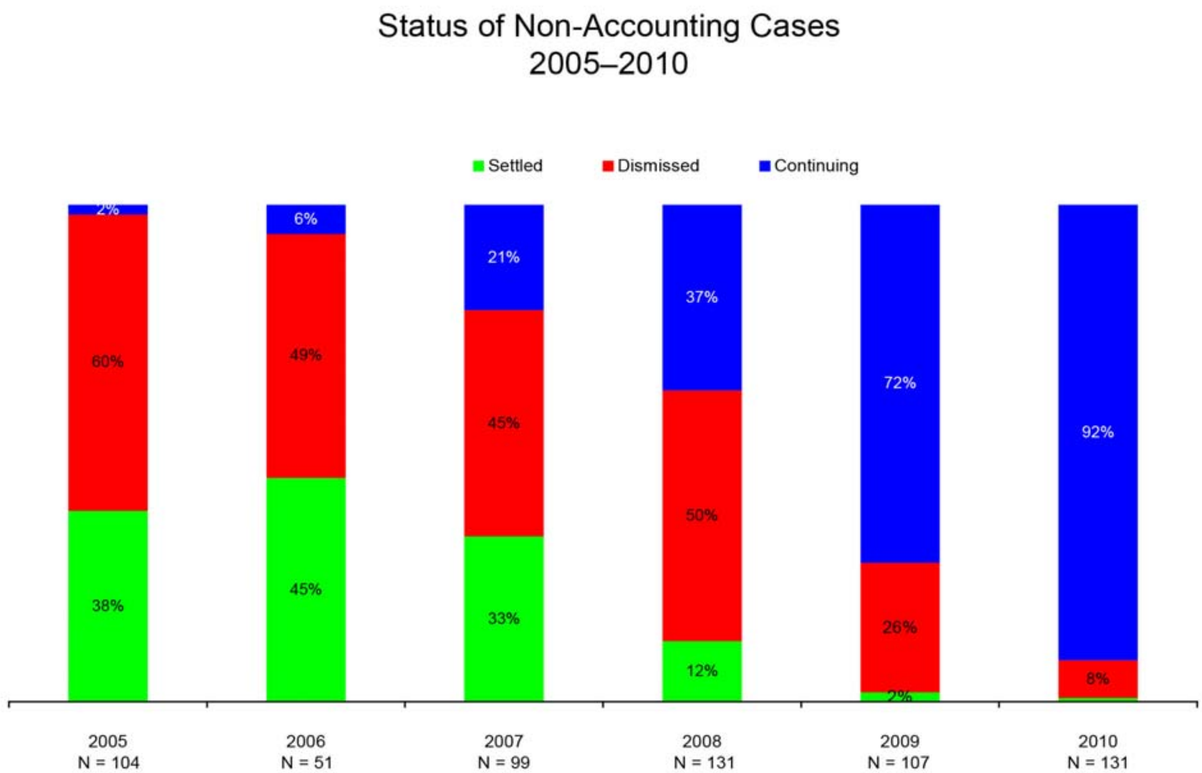
In recent years, many of the largest securities class actions filed have involved allegations that a company issued financial statements that did not conform with generally accepted accounting principles (accounting cases). In fact, from 2005 through 2010, 19 of the 20 largest settlements of securities class actions were all accounting cases. Given the rise of public attention to accounting issues, as well as the recent changes in the accounting regulatory environment, we conducted research to study how accounting cases differ from other securities class action filings (non-accounting cases).

Accounting Case Filings and Settlements

The research shows that accounting cases are less likely to be dismissed. Figure 1 below compares the status of accounting and non-accounting cases at the end of 2010. For example, of the securities class actions filed in 2005, only 36 percent of accounting cases were dismissed by the end of 2010 compared to 60 percent of non-accounting cases (shown in red). Figure 1 also shows that accounting cases take longer to resolve than non-accounting cases. For example, of the class actions filed in 2008, 51 percent of accounting cases were continuing at the end of 2010, compared to 37 percent of non-accounting cases (shown in blue).

Figure 1


Status of Accounting Cases
2005–2010
Settled
Dismissed
Continuing
36%
64%
7%
37%
56%
22%
31%
47%
51%
29%
21%
74%
23%
3%
98%
2%
2005
N = 78
2006
N = 68
2007
N = 78
2008
N = 91
2009
N = 61
2010
N = 45


Status of Non-Accounting Cases
2005–2010
Settled
Dismissed
Continuing
2%
60%
38%
6%
49%
45%
21%
45%
33%
37%
50%
12%
72%
26%
2%
92%
8%
2005
N = 104
2006
N = 51
2007
N = 99
2008
N = 131
2009
N = 107
2010
N = 131

The fact that accounting cases are less likely to be dismissed and take longer to resolve may be the result of the greater complexity of these cases. This means that aside from the ultimate settlement amount, the costs to litigate these cases will typically be larger than non-accounting cases.

In addition to being less likely to be dismissed, accounting cases are associated with higher average settlements. Although accounting cases represented only 67 percent of all cases settled from 2005 through 2010, they accounted for 92 percent of total settlement dollars. For example, in 2006, accounting cases represented 64 percent of the cases settled but 97 percent of total settlement dollars (Figures 2 and 3). The same general pattern of relatively greater settlement dollars than number of cases settled holds over all six years in our study, though it is most pronounced in 2006 and 2007 when a number of settlements in excess of $1 billion were approved (cases such as *Nortel Networks*, *AOL Time Warner*, *Enron*, and *Tyco International*).

Figure 2

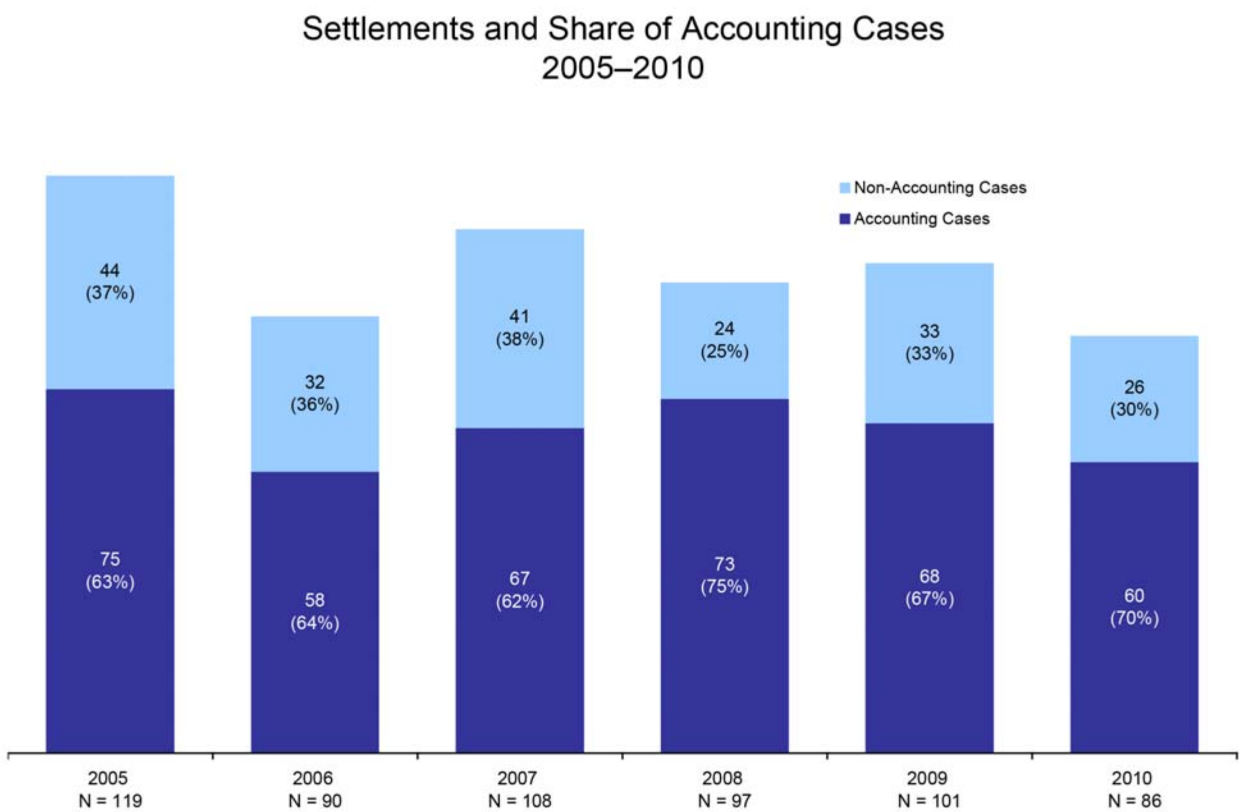
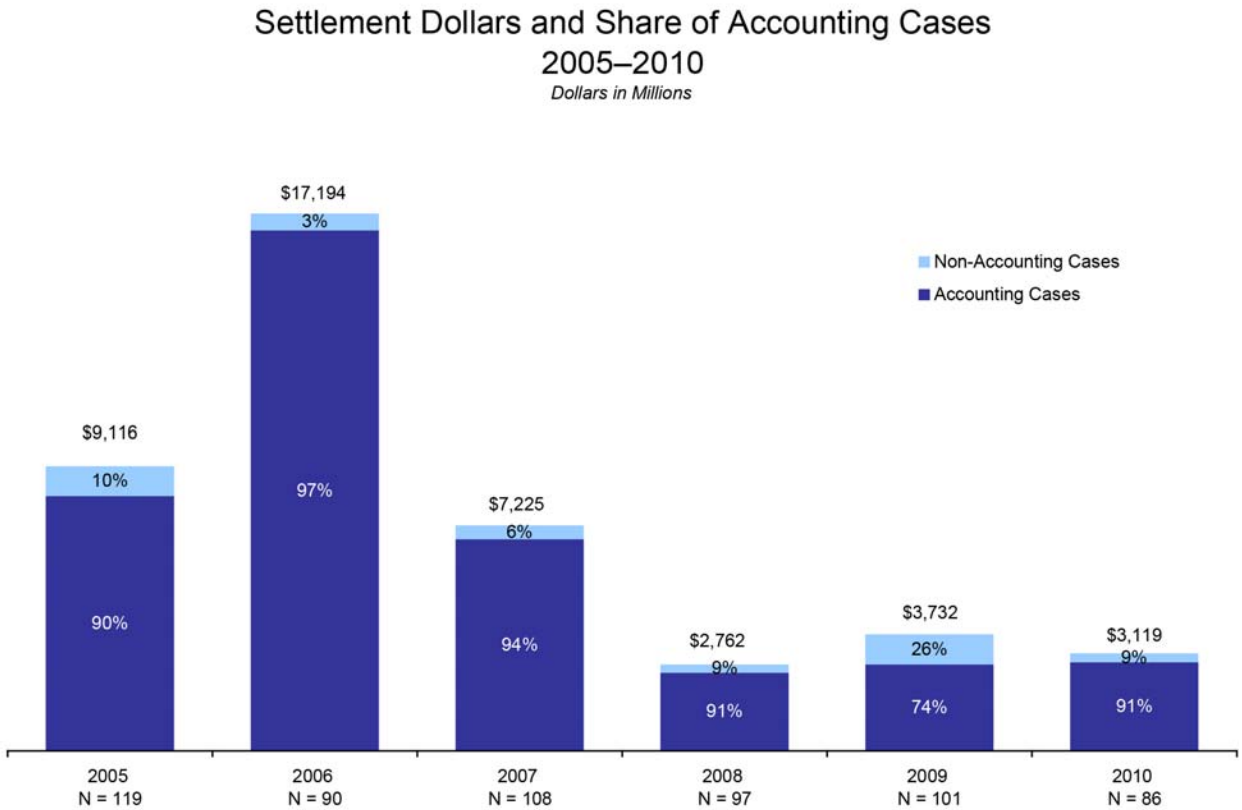


Figure 3



In the class actions we studied, all but one of the non-accounting cases settled for $200 million or less from 2005 through 2010. In contrast, more than 5 percent of accounting cases settled for amounts in excess of $300 million during that time period. Defendants will typically pay more to settle accounting cases, as evidenced by a substantially higher median settlement of $10.1 million for accounting cases versus $5.9 million for non-accounting cases.

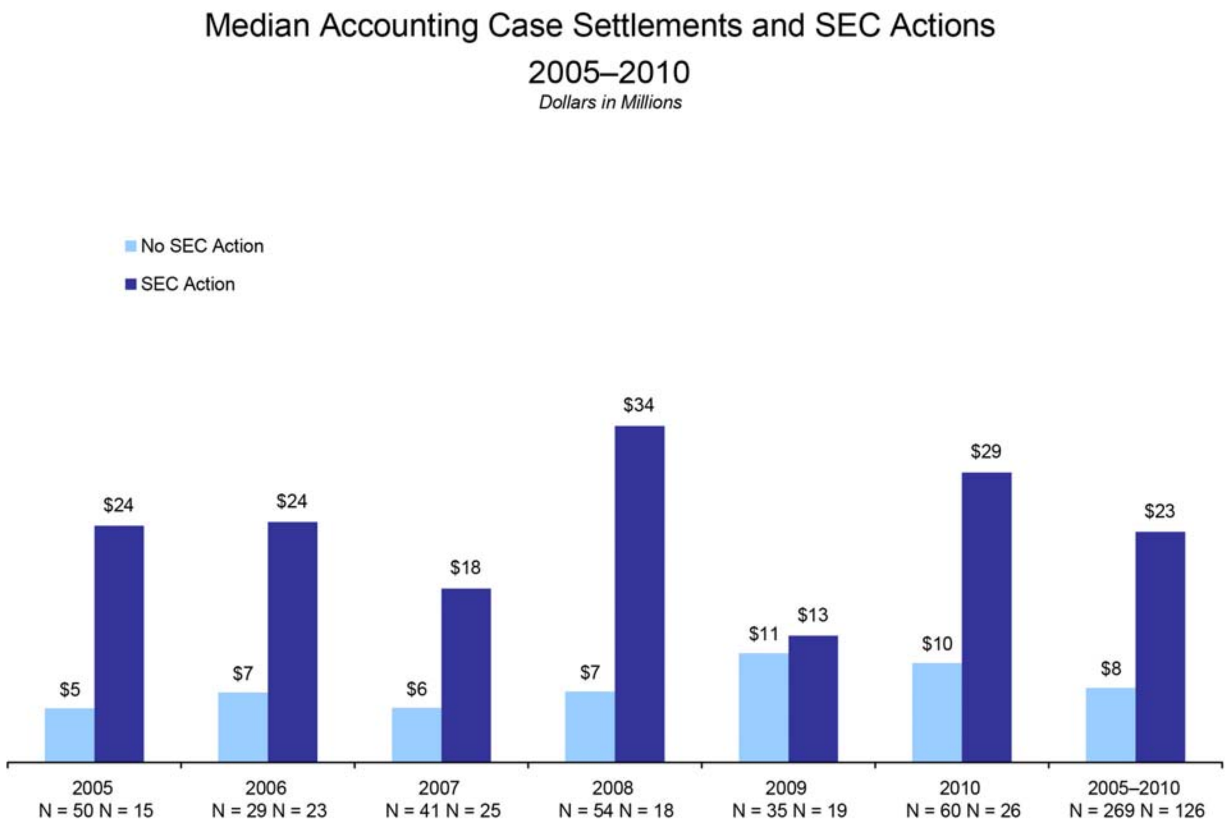
For potential defendants, one piece of interesting news is that during 2010 the percentage of accounting cases filed was the lowest it has been in a number of years (26 percent in 2010 as compared to an average of 44 percent over the preceding five years). Whether this decrease signifies a trend that will change the overall cost of settling accounting cases in the future remains to be seen.

Characteristics of Accounting Cases

The SEC brought actions against defendants—as evidenced by filings of litigation releases or administrative proceedings—in approximately one-third of the settled accounting cases in our sample. In contrast, SEC actions occurred in only 12 percent of settled non-accounting cases. One explanation for this difference is that the SEC may be more likely to investigate and bring actions in accounting cases, particularly during recent years in which there has been an increased focus on accounting issues.

The presence of SEC actions corresponds to higher class action settlements. Of the accounting cases settled from 2005 through 2010, accounting cases with and without SEC involvement had median settlements of $23.2 million and $7.5 million, respectively (see Figure 4 below).

Figure 4



We also examined the impact of two different types of accounting events: restatements and write-downs of assets. Interestingly, while cases involving allegations relating to financial statement restatements are less likely to be dismissed, they do not necessarily result in higher settlements. The median settlement for both accounting cases referencing restatements and accounting cases referencing neither restatements nor write-downs was $10.5 million. On the other hand, cases that settle for amounts in excess of $100 million (typically referred to as mega-settlements) tend to involve restatements. Thus, while the median settlement amount for cases in our sample is unaffected by the presence of financial statement restatements, the mean settlement amount for accounting cases referencing restatements was $146.5 million versus $30.0 million for cases with neither a restatement nor a write-down.

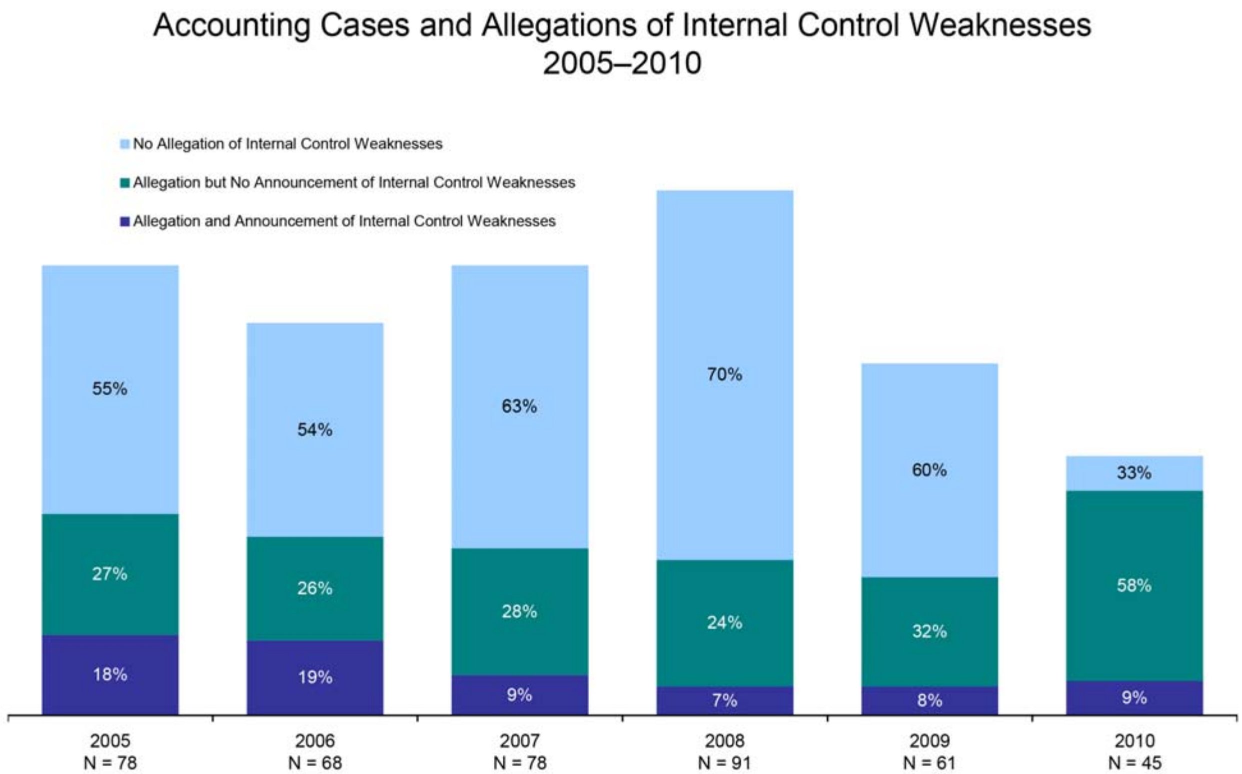
The median settlement for accounting cases involving asset write-downs was $6.0 million—significantly lower than that for other accounting cases. One possible explanation is that allegations in cases with write-downs, including allegations that the write-downs should have been taken sooner, may be more difficult to prove than allegations in other cases and thus may result in lower settlement amounts.

We also examined the relationship between internal control weaknesses and settlements. Under the provisions of Section 404 of the Sarbanes Oxley Act (SOX), public companies and their independent auditors are each required to report on the effectiveness of a company's internal controls. For accelerated filers (companies with a public float in excess of $75 million), this requirement became effective for fiscal years ending on or after November 15, 2004.

Among accounting case settlements that included allegations of internal control weaknesses, more than half included company announcements of internal control weaknesses. Cases with both plaintiff allegations and company announcements of internal control weaknesses had a median settlement amount of $13.5 million. This is significantly higher than cases in which plaintiffs allege internal control weaknesses absent an accompanying company announcement of internal control weaknesses ($9.3 million) and also higher than amounts for cases with no allegations of internal control weaknesses ($9.0 million).

Allegations of internal control weaknesses have increased in recent years (see Figure 5 below). For example, the percent of cases with allegations of internal control weaknesses increased from 40 percent in 2009 to 67 percent in 2010. However, the increase is most pronounced for cases filed in which plaintiffs allege internal control weaknesses but there was no accompanying company announcement of control weaknesses. Allegations accompanied by company announcements of internal control weaknesses have actually declined in recent years, from 18 percent of accounting cases in 2005 to 9 percent in 2010. It is possible that improvements in corporate governance and internal controls as a result of SOX have led to fewer announcements of internal control weaknesses. It will be interesting to observe whether complaints will continue to include allegations of internal control weaknesses absent company announcements of such weaknesses, given that such allegations are not associated with significantly higher settlement amounts.

Figure 5



Conclusion

In recent years, securities cases that include accounting allegations have differed in significant ways from other securities class action filings. If recent trends continue, accounting cases will be less likely to be dismissed and more costly to litigate, and will lead to higher settlement amounts. These differences can be important in determining litigation strategy.

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