



The Stock Market Reaction to Securities Class Action Filings

Salma Damak^{1*}, Hend Guermazi², Adel Beldi³

¹IHEC, University of Carthage, LIGUE, University of Manouba, Tunisia, ²IHEC, University of Carthage, LIGUE, University of Manouba, Tunisia, ³IESEG School of Management, Univ. Lille, CNRS, UMR 9221 - LEM – Lille, France. *Email: salma.damak@ucar.tn

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ABSTRACT

The purpose of this paper is to investigate stock price reaction to securities class action filings. A standard event study methodology, employing the market model, is applied to determine the abnormal returns both on and surrounding the lawsuit filing day. We utilize the Stanford Securities Class Action Clearinghouse Database (SCAC) to collect the initial sample, which contains data on all securities class action. Insofar as we have eliminated any event that could contaminate the event to capture only the effects linked to the announcement, our sample is then restricted to three events corresponding to three different companies. The results show the absence of a significant reaction for the ten days preceding the lawsuit filings as well as for the ten days following the lawsuit filings. This paper uses stock market reaction to gauge the merit of Securities class action (SCAs) and the results shows that the market has a modest ability to discern meritorious filings from frivolous filings.

Keywords: Lawsuits, Filing, Event study, Securities Class Action, Frivolous lawsuit

JEL Classification: G120, G140

1. INTRODUCTION

Financial scandals like Enron, WorldCom and others have demonstrated that U.S. securities class actions can have serious consequences for corporations. Companies face all sorts of lawsuits and corporate litigation represents a major source of risk to the firm.

Securities class action represent a central pillar of the U.S. litigation and corporate governance system. Koku et al. (2001) indicates that the United States is the most litigious nation on earth. The Securities Act of 1933 and the Securities Exchange Act of 1934 govern most securities litigation. Although, the increasing explosion of litigation in the United States may be due to a rather interesting phenomenon namely frivolous lawsuit, class action lawsuits can be effective tools to address social and environmental injustices.

Certainly, there is the concern that class action litigation is not always merit-based (Peng and Roell, 2008). The passing of the

Private Securities Litigation Reform Act of 1995 was intended to make it more difficult to initiate shareholder lawsuits by requiring plaintiffs to provide proof that executives intentionally defrauded investors. Related claims are brought forward by plaintiffs who suffered an economic loss in the consequence of the adjustment of inflated or deflated share prices following the revelation of misconduct (Lieser and Kolaric, 2016).

Rosenberg and Shavell (1985) note that it is impossible for the courts to exercise much control over the quality of claims. Consistent with this view, in this paper, we investigate do class action filings affect stock prices? In fact, this type of event inevitably conveys bad news. This line of reasoning has led to the application of the event study methodology to analyzing the financial effects of securities class action (Bhagat and Romano, 2002; Koku and Qureshi, 2006). Event study methodology is a powerful tool that has been exploited heavily in academic studies in finance since it was first introduced by Fama et al. (1969).

The remainder of this article is organized as follows. Section 2 reviews prior literature on securities class actions. Section 3 describes the data selection process and the sample composition. It also explains the empirical methodology in detail. Section 4 presents the results of the empirical analysis and Section 5 provides a summary of the main findings and concludes the paper.

2. LITERATURE REVIEW

Securities class action (SCA) lawsuits are a fundamental pillar of the U.S. corporate governance system and a critical event in the life of a firm. SCA are a special case of the U.S. class action. A very distinctive feature of the U.S. class action is that many individual claims together into a single lawsuit that can support the cost of litigation. Indeed, Securities class action (SCA) are brought by investors who bought or sold a company's publicly traded securities within a specific period of time known as a "class period" and suffered economic injury as a result of violations of the securities laws. Previous empirical studies have devoted much research effort to understanding the stock market's reaction to news on class action. It has been shown that the SCA have a wide array of consequences for the sued firms.

McCarten and Diaz-Rainey (2017) noted that several previous studies have found a negative market reaction to the filing of a class action. However, Chava et al. (2010) note that if the lawsuit filing is foreseeable when the lawsuit-triggering disclosure is made, there will be no further market reaction when the lawsuit is filed.

Romano (1991) presents the first event study on lawsuit filings on a random sample of publicly traded firms sued between 1966 and 1987. She does not observe any significant abnormal returns for lawsuit initiations. However, subsequent studies (Arena and Julio, 2015; McTier and Wald, 2011) have found that there is a relationship between securities class actions and firms' investment decisions. Deng et al., 2014 have found a relationship between SCA and the company's reputation.

Several prior studies on price effects of shareholder-initiated lawsuits have noted negative price reactions to shareholder litigation related events. Griffin et al. (2004) document significantly negative returns with approximately -4.1% on the lawsuit filing day. Moreover, Fich and Shivdasani (2007), shows a significant negative market reaction around the fraud lawsuit filing date of -5.95%. The study by Pritchard and Ferris (2001) examines price reaction to the conclusion of shareholder-initiated class action lawsuits. They find a large and statistically significant negative reaction to the revelation of potential fraud, and a smaller but still statistically significant reaction to the filing a lawsuit.

Using event study methodology, Bohn and Choi (1996) found that SCA filings resulted in a statistically significant stock price drop around a three-day window of the time of filing regardless of merit, and that the market did not fully anticipate the filings. They looked at all filings for a twelve-year period covering 1975 to 1986.

Gande and Lewis (2009) examine a significantly larger sample than those employed in other studies of security class action lawsuits

filed between 1996 and 2003 and confirm significantly negative stock price reactions at the announcement. Klock (2015) obtains results consistent with those of Gande and Lewis (2009) for a sample of class action lawsuits between 1995 and 2012. Based on this prior research, we expect to see similar reactions to the lawsuit filing.

3. DATA AND METHODOLOGY

This paper uses the event study methodology that makes it possible to measure the stock price reactions as a result of the announcement of unanticipated events (Fama et al., 1969). Following their study, event studies have become the predominant method for determining the effects of an event on stock prices.

To conduct an event study, we must first identify and define the event. Moreover, the type of announcement or event under consideration should be unambiguously defined. Indeed, the event studied in our paper will be the lawsuit filing like several previous studies (Arena and Julio, 2015; Hickox et al., 2016; Huang et al., 2017). Besides, Griffin et al. (2004) attribute the market reaction to the filing of the lawsuit and not to the disclosure event.

So, we follow an event study methodology and measure the share price response to the lawsuit filing date over the event period employing the market model to determine the abnormal returns both on and surrounding the lawsuit filing date. Like many previous studies (Arena and Julio, 2015; Barabanov et al., 2008; Gande and Lewis, 2009; Gande and Miller, 2012; Klock, 2015; Hickox et al., 2016; Huang et al., 2017), we utilize the Stanford Securities Class Action Clearinghouse Database (SCAC) to collect the initial sample, which contains data on all securities class action. The first step was to download information about all filings for our sample NASDAQ 100 from the beginning of the database in January 2013 to December 2015. This provided 9 securities class-action filings. In fact, here should not be any other disruptive episodes within the tested event windows. Therefore, we have eliminated companies with confusing and confusing events such as quarterly earnings announcements, merger announcements, announcement of change in management and any unexpected information or events disclosed around the date announcement to ensure that no other event other than the event has occurred. Insofar as we have eliminated any event that could contaminate the event to capture only the effects linked to the announcement, our sample is then restricted to three events corresponding to three different companies.

The significance of the stock price reaction during the event window is habitually evaluated relative to what is referred to as the normal return period. The normal return period is the usually a long window prior to the event window over which the variance of abnormal returns is estimated. To conduct an event study, the length of the estimation period must be specified. The estimation period used in our study, to estimate the parameters of the model, is located 200 days before the date of the event ($t = -200$) until the 11th day before the date of filing ($t = -11$). Therefore, the filing date is zero day, the days before the filing date are negative, and the days after the filing date are positive. As for the event window, we

opted for 3 different windows (-10, -2); (-1, +1); (+2, +10) rather than the standard window (-1, +1). Indeed, the choice of the event window determines whether we capture the partial anticipation of the trial and any more confidential prior broadcasts and whether we will consider the additional information that arises after the filing. We assume these windows are long enough to capture the impact. Thus, day -10 represents two weeks before the date of the event, and day +10 is two weeks after the date of the event since the markets are closed on weekends. So, the event window includes 10 trading days before the event date and 10 trading days after that date. The use of 3 different windows was also made by Gande and Lewis (2009); Klock (2015) and Lieser and Kolaric (2016). In fact, the choice to look at three windows was motivated by a better interpretation. To compensate for the possible anticipation and additional information that arose after the deposit, we use three event windows (-10, -2), (-1, +1) and (+2, +10) rather than just the standard window (-1, +1) around the filing date of the lawsuit which is short, and which probably underestimates the reaction of the market. Focusing on short windows around the lawsuit filing date undoubtedly underestimates the market reaction to securities class action filings. We assume that the first and third windows are long enough to capture the impact of the filing of the class action lawsuit.

The Table 1 recapitulates the windows used in previous studies using the event study method dealing with the class Action Filings.

Throughout our analysis, we define day 0 of a lawsuit as the corresponding filing date in SCAC and focus on various event windows surrounding this date drifts.

Consistent with previous studies (Fama et al., 1969; Koku et al., 2001), we measure the share price response to the lawsuit filing date over the event period using the market model. Thus, the normal return on a given day t for security i is:

$$E(Ri,t) = ai + bi Rm,t$$

Where the parameters α and β are estimated from a regression of $R_{i,t}$ on $R_{m,t}$ during the estimation period using data from days -200 through -11.

Following standard event study methodology, we use daily abnormal returns (ARs). To capture the effect of any event on

firm i , abnormal returns are calculated around the event date. Subsequently, for each day t during the event window and for each company i we calculated the abnormal returns by deducting the estimated returns from the real returns as:

$$ARit = Rit - E(Rit)$$

According to Klock (2015), the abnormal for firm i at time t is just the actual return less its expected return, and the expected return is based on the market model, which models the return of the firm as a function of the market portfolio return using the firm's specific parameters α and β . The abnormal returns are considered as the reaction of the market to the filing of the class action lawsuit.

Before resorting to statistical tests, it is first necessary to verify the normality of the distribution of errors. Campbell and Wasley (1993) considered that "Normality of abnormal return measures is a key assumption underlying the use of parametric test statistics in event studies." And they document "a substantial degree of nonnormality in the daily returns of NASDAQ securities that persists even at the portfolio level."

So, using the MiniTab 17 software, we verified the distribution of abnormal returns for the three companies in our sample. The application of the Anderson-Darling statistical test has shown that the residuals of the market model applied over the estimation period do not follow the normal distribution ($P < 0.05$). Therefore, the assumption of normality is not verified.

Cumulative abnormal returns (CAR) are also calculated for the following event windows: (-10; -2), (-1;+1), and (+2;+10). Using these event windows, anticipation effects, event effects, and post-lawsuit effect of abnormal returns are accounted for. The CAR calculation follows:

$$CAR_{t1,t2} = \sum_{t=t1}^{t2} ARit$$

Average cumulative abnormal returns (ACARs) are calculated in the usual manner by summing the individual CARs of all n events for the event window $[t_1; t_2]$ using:

$$ACARt = \sum_{t=t1}^{t2} CARit$$

Table 1: Some studies focusing on securities class action

Study	Estimation period	Day 0	Windows
Gande and Lewis (2009)	The estimation period for estimating the parameters of the market model is 125 trading-day from day-135 to day-11.	The lawsuit filing date	Three windows are examined: (-10, -2), (-1, +1) et (-10, +1).
Klock (2015)	The estimation period for estimating the parameters of the market model is 255 trading days (approximately one year) and ends at day-46	The lawsuit filing date	Three windows are examined: (-30, -2); (-1, 0); and (+1, +30)
Huang et al. (2017)	Period from trading day-252 to-22 relative to day 0	The lawsuit filing date	Two event windows: a long (-10, +1) one and a short [-3, +1] one.
Haslem et al. (2017)	120-day estimation window ending on Day -31.	The lawsuit filing date	Three different event windows: (-10, 1), (-1, 1), and (-10, 10)

4. RESULTS

Three windows are examined: $(-10, -2)$; $(-1, +1)$; and $(+2, +10)$. For each average cumulative abnormal return (ACAR), a statistic test is reported which tests the null hypothesis, which is defined by the absence of average abnormal returns.

The following Table 2 illustrates the results of the One sample T-Test which tests the null hypothesis using the software Minitab 17.

If, for the analysis of Table 2, we only consider the T, we notice that the Student's T-test in absolute value of the ACAR (1.97) for the window $(-10, -2)$ is slightly higher at the critical value of 1.96. Thus, a T-test is considered significant at the 5% confidence level if it is greater than 1.96 in absolute value. Therefore, we reject the null hypothesis which results in the absence of cumulative abnormal returns, resulting in a negative reaction at the 5% level.

However, by analyzing the p-value for the same window, the result is contradictory. Indeed, the p-value is used to quantify the statistical significance of a result under the null hypothesis ($H_0: ACAR = 0$). The general idea is to prove that the null hypothesis is rejected. The procedure generally employed consists in comparing the p-value with a previously defined level, (traditionally 5%). If the p-value is less than this level, we reject the null hypothesis in favor of the alternative hypothesis ($H_1: RAMC \neq 0$), and therefore the test result is declared "statistically significant." Otherwise, if the p-value is greater than the level, we accept the null hypothesis.

Table 2 shows the p-value is greater than the 5% threshold for all three windows. However, this result contradicts the result found through the T-test for the pre-filing $(-10, -2)$. Indeed, from a statistical point of view, the p-value is the most important tool to interpret the result of a test. So statistically, we are allowed to accept H_0 at threshold of 5% which is defined by the absence of average abnormal returns. Thus, the statistical analysis of abnormal returns via a Student's test in our case is not recommended since the assumption of normality has not been validated. These results could be validated more precisely by non-parametric tests. we used two non-parametric tests namely the sign test and the rank test.

So, the following Table 3 illustrates the results of the sign test.

As a result, we notice from the sign test that $p > \alpha$ (5%) for all three windows. Therefore, we accept H_0 which assumes the absence of cumulative average abnormal returns at the event's announcement, hence the absence of a significant reaction. This test only confirms the results of Student's tests. Subsequently, we tested the same

hypotheses by the rank test. In fact, Campbell and Wasley (1993) recommend the use of the rank test in NASDAQ samples.

The following Table 4 illustrates the results of the Wilcoxon test for cumulative abnormal returns.

From the results obtained from the rank test, we also found that ($P > 5\%$) for the three windows, so we accepted the null hypothesis which results in the absence of cumulative average abnormal returns.

In conclusion, we summarize all the results of the three tests in the following Table 5:

Table 5 shows that, based on the Student test and the two other non-parametric tests, the absence of a significant reaction ($P > 0.05$) around the filing. Indeed, it should be noted that the class actions lawsuits constituting our sample were all rejected posteriori. Thus, the first case was voluntarily dismissed without prejudice, the second case was dismissed against the defendants as to the third case, it was dismissed with prejudice. So, the resolution of the three lawsuits is rejection nonetheless each in a different way from the other. Interpreting these results is quite tricky as the evidence indicates that lawsuits tend to be frivolous. Therefore, our results lead us to believe that the market has a modest ability to discern meritorious filings from frivolous filings.

Indeed, the term "frivolous" appears in previous studies of litigation often in opposition to the term "merits." So, according to Baker and Griffith (2009) "*a lawsuit is frivolous if the facts that the plaintiff alleges are false or if the plaintiff's legal theory is unsound. By extension, the merits do not matter if the probability that the facts are false, or the legal theory is unsound does not strongly affect the resolution of the case*".

However, we notice that the p-value of the first window $(-10, -2)$ for the rank test (0.097) is closest to the usual statistical threshold (5%). The p-value of the second window $(-1, +1)$ which contains the filing date is the furthest from the level of 5%. So, the filing itself may contain little new information about the alleged misconduct that may be revealed and incorporated into the stock price prior to filing. So, we sight that the absence of the "surprise element" weakens the information content of filing announcements consequently share prices do not react due to the absence of new information.

Huang et al. (2017) explained the pre-filing reaction by the fact that potential class actions were usually publicly disclosed or even reported in the media when law firms gathered sufficient number of shareholders, claims. Haslem et al. (2017) note that "*the lawsuit*

Table 2: The results of one-sample t-test

Variables	N	Test of $\mu = 0$ vs $\neq 0$					
		Mean	SD	SE mean	95%CI	T	P
ACAR $(-10, -2)$	9	-0,00289	0,00440	0,00147	(-0,00628; 0,00049)	-1,97*	0,084
ACAR $(-1,+1)$	3	0,00211	0,00383	0,00221	(-0,00739;0,01162)	0,96	0,440
ACAR $(+2,+10)$	9	0,00156	0,00753	0,00251	(-0,00423; 0,00735)	0,62	0,551

*Indicates statistical significance at the 5% level

Table 3: The results of the sign test

Test of median=0,000000 versus median≠0,000000						
	N	Below	Equal	Above	p	Median
ACAR (-10, -2)	9	7	0	2	0,1797	-0,00241
ACAR (-1,+1)	3	1	0	2	1,0000	0,00113
ACAR (+2,+10)	9	4	0	5	1,0000	0,00328

If $P \leq \alpha$ (5%), H_0 is rejected and H_1 is accepted. If $P \geq \alpha$ (5%), H_1 is rejected and H_0 is accepted

Table 4: The results of Wilcoxon Signed rank test

Test of median=0,000000 versus median≠0,000000					
	N	Test	Statistic	P	Median
ACAR (-10, -2)	9	9	8,0	0,097	-0,002592
ACAR (-1,+1)	3	3	5,0	0,423	0,001867
ACAR (+2,+10)	9	9	29,0	0,477	0,001596

Table 5: Summary of the results of the three tests

	N	One-sample T-test	P-value sign test	P-value rank test
ACAR (-10, -2)	9	0,084	0,1797	0,097
ACAR (-1, +1)	3	0,440	1,0000	0,423
ACAR (+2, +10)	9	0,551	1,0000	0,477

filing date may be preceded by the date associated with the first information release”.

In addition, Gande and Lewis (2009) find that shareholders partially anticipate these lawsuits based on lawsuits against other firms in the same industry. For his part, Klock (2015) also found a statistically significant negative abnormal return during the weeks preceding the filing indicating that the market partially, but not fully, anticipates these filings. As for the filings that were subsequently rejected, there was a negative but small impact, indicating that the market can distinguish between applications with different degrees of merit. Indeed, Klock (2015) considered the dismissal of a lawsuit as an indicator of frivolous behavior.

Indeed, the leak of information or the pre-disclosure of information relating to the filing of a class action lawsuit is often beneficial because it disperses the reaction and the fall in stock prices over several periods.

Indeed, we suspected, at the beginning, that the filing of a complaint provides new information to the market, whether it is based on merit or not, will lead to a stock market reaction especially as Basu (1997) confirmed that bad news is reflected in stock prices earlier than good news.

However, our results showed that the US market can distinguish between frivolous class actions and merit-based class actions. It should be noted that the three filings studied were rejected posteriori, so we can consider that the rejection is a strong indication that the lawsuits were frivolous during the filing. Klock (2015) also reported that “*Obviously, the market cannot observe dismissal at the time of filing.*”

So, our study illustrates a very controversial phenomenon in the securities industry namely the frivolous lawsuit. We can consider

the three lawsuits investigated as frivolous, but that the plaintiffs chose to sue the corporations believing they have a better chance of winning which they did not.

According to Dyck et al. (2010), class action law firms have automated the filing of class action suits by reacting to any negative shock to share prices, it is highly unlikely that a value-relevant fraud could emerge without a subsequent class action suit being filed.

In fact, the relational repercussions of class actions are an increasingly important variable in risk assessment. Thus, being engaged in a lawsuit, even, classified as frivolous and which does not have a significant effect on stock prices could damage the perception of the brand as well as the reputation of the company. In fact, Haslem et al. (2017) confirmed that the impact of litigation does not just include penalties and legal fees, but also other factors and costs that are much more difficult to quantify “*One such cost is the damage to the defendant’s reputation that leads to decreased revenues and increased costs of contracting with suppliers, employees, or shareholders.*”

5. CONCLUSIONS

U.S. securities class actions can have far-reaching consequences for corporations, as cases like Enron, WorldCom and, and others strikingly demonstrate. So, exposure to securities litigation risk affects firms in various ways, both directly and indirectly.

To study the impact of a filing of a class action on the American financial market, we adopt the methodology of the event study which consists in examining stock price movements around the event. The choice to focus on securities class action lawsuits is motivated by several reasons. In fact, securities class action are brought under the Securities Act of 1933 and the Securities Exchange Act of 1934. As such, all publicly traded firms are susceptible to this lawsuit. In addition, detailed information related to the class action lawsuits is publicly available for a longer period than that for other types of lawsuits.

So, by studying the impact of a securities class action filings, we think the share price will go down, but this is not always the case. We employed the market model for the calculation of abnormal returns. The results that emerge from our study have shown that the market reaction will depend on the type of lawsuits. In fact, not all cases have the same merit. We noticed the absence of a significant reaction when filing class actions against the companies constituting our sample. It should be noted that the three filings studied were rejected posteriori, so the rejection could be considered as a strong indication that the lawsuits were frivolous during the filing. So, our study illustrates a very controversial phenomenon in the securities industry namely the frivolous lawsuit. Interpretation of these results leads us to conclude that the American market is able to detect the importance of lawsuits even at the time of filing.

This paper contributes to the existing literature on SCA in using event study methodology to investigate the stock price reactions to

securities class action filings to gauge the merit of SCAs. However, our study suffers from several limitations. Its principal limitation relates, essentially, to sample size that is not representative. So, the small number of companies may not permit a definitive view to be established about the stock market reaction. The second limitation relates to choose of the date of the event, namely the date of the filing of class actions which may be replaced by the date of the decision when the court decides to grant or reject the request which may be the time when the course of the action reacts most significantly to new information.

Our findings highlight the need for future research to examine if the market responds to the resolution of these lawsuits.

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