The Legal Intelligencer

THE OLDEST LAW JOURNAL IN THE UNITED STATES 1843-2009

PHILADELPHIA, FRIDAY, DECEMBER 18, 2009 VOL 240 • NO. 121 $5.00 An ALM Publication

SECURITIES LAW

Are Stealth Financial Reporting Studies a Warning for Buyer to Beware?

BY JEFFREY A. BARRACK
Special to the Legal

In September 2006, this column ran a headline commenting on the Supreme Court decision in *Dura Pharmaceuticals v. Broudo*: "Does High Court Mean the Buyer Must Beware in Securities Markets?" Addressing loss, or proximate, causation — the causal connection between a defendant's material misrepresentations and a plaintiff's losses — *Dura* held that the securities fraud action provides redress only for the "loss the purchaser sustains when the facts become generally known and as a result share value depreciates." In other words, the evidence must show that a plaintiff's losses are attributable to some form of revelation of wrongfully concealed or misrepresented information.

Commenting on the decision in the spring of 2006, Columbia University law professor John Coffee explained in a column for *Legal* affiliate the *New York Law Journal* that *Dura* had become "a weapon" for defense counsel as a basis for new defense tactics. Coffee explained that because "market declines prior to the time of the corrective disclosure may escape liability, the issuer now has an incentive to modify its approach to disclosure, leaking out adverse information to the market on a not for attribution basis." If such information can "reach the market in vague and generalized terms … then defendants may be able to diminish expectations [and] break up the likely stock price decline … ." Coffee also explained the technique of "bundling … adverse and favorable information together" to lessen the blow of bad news.

Managing the dissemination of curative information using the tactics that Coffee discussed — tactics that in the three years since have become known as "stealth reporting" practices — attenuates the effect of new information on stock price, making it more difficult to adduce evidence establishing proximate economic loss in a securities action. Econometric researchers have picked up on this market phenomenon and started studying it.

Rebecca Files, of the University of Texas at Dallas, together with Edward Swanson and Senyo Tse, of Texas A&M University, studied various levels of "disclosure prominence" when companies reported accounting restatements to answer the question of whether companies are "rewarded or penalized for openness in disclosing bad news." Their study, titled "Stealth Disclosure of Accounting Restatements," updated in April, investigated whether the prominence given to a restatement in a corporate press release affects market prices and litigation. Using statistical modeling, the study found that companies providing less prominent press release disclosure of a restatement are rewarded with a less negative stock price reaction at the time of the announcement. The study noted that this reward dissipated over the 20 following days. The study also found that companies providing less prominent disclosure are less likely to be sued for securities fraud.

Files conducted another study in February seeking answers to the related question of whether more transparent corporate disclosure of a restatement influences the SEC's decision to commence an enforcement action. Her study found, prior to the implementation of Sarbanes-Oxley, that greater restatement transparency increased the likelihood of an SEC sanction. In addition, an April study by Brian Hogan of Northeastern University and Julia Grant of Case Western Reserve University testing the characteristics of institutional investor ownership changes surrounding company restatement disclosure levels found that companies "issuing stealth restatements (low disclosure) appear to avoid negative market consequences."

> *The recent stealth disclosure studies demonstrate that the window for any event study in a securities fraud action must begin upon the initial disclosure of the risk previously concealed or misrepresented by the defendant and it must extend through the moment the market fully appreciates that risk.*

These stealth disclosure studies each reportedly controlled for factors such as the seriousness of the violations of generally accepted accounting principles, restatement magnitude, restatement characteristics, company characteristics and other controls. Writing for *The Northeastern Voice*, Susan Salk interviewed Hogan, who explained that stealth disclosures of restatements are made by corporations to create "a lag" between the time the information is released and the time it affects stock prices trading in the market.

These studies have been reported by the financial press with grand headlines, like the Sept. 28 Reuters headline that read: "Companies That Bury Bad News Reap Rewards Over Forthright Firms." The articles in the financial press seem to suggest that corporate reporting personnel have learned that "it pays to relegate the bad news to a footnote."

But advocates for greater transparency in financial reporting have developed methods to measure economic losses caused by misleading statements even where stealth disclosure techniques are used to announce corrective information. As one plaintiffs securities lawyer explains, sound econometric technique may serve to prevent financial reporting personnel using stealth reporting practices from "gaming the system."

JEFFREY A. BARRACK
is a partner at Barrack Rodos & Bacine. He can be reached at 215-963-0600 or at jbarrack@barrack.com.

The econometric tool known as the "event study" is a forensic tool sensitive enough to scientifically support a finding of proximate economic loss where nuances have been created by stealth disclosure tactics. The event study is based on the principle that publicly available information relevant to the valuation of a company is incorporated into stock prices such that the market price of a company's equity responds to new company-relevant information. The "event" is an informational disclosure; the "event window" is the period over time during which that disclosure is deemed to have an effect.

The event study has been praised by courts as a thorough, sophisticated and well-substantiated method for detecting causation and measuring economic loss in securities litigation. Event studies may be used to address events where there is a series of nuanced communications that release information to create a false impression that factors other than a disclosed problem or fraud were responsible for any share price decline.

Financial economics professor Bradford Cornell explained in his article, "Using Finance Theory to Measure Damages in Fraud-on-the-Market Cases," that to address circumstances where "a fraud is revealed slowly over time" one need only "extend the observation window" to end "at a date when the analyst feels confident that most of the information is publicly available." The effect of new information cumulates over the period of observation to accurately measure the market's appreciation of it. According to Cornell, the "length of the window depends on the facts of each specific case." Thus, it is appropriate, and at times necessary, to adjust the event window to enhance precision in detecting causation and measuring economic loss where there are the types of disclosure tactics analyzed by the recent stealth disclosure studies. Importantly, courts have accepted expert analysis where the cumulative returns associated with such longer disclosure events provides a satisfactory methodology for determining loss causation.

Indeed, Files, Swanson and Tse's study on stealth disclosure of accounting restatements specifically tested the viability of extended event windows on stealth restatement disclosures for measuring economic losses. They extended the event window to 20 days in their study of stealth restatement disclosures. The study concluded that while "market participants initially underestimate the seriousness of some misstatements disclosed without a headline, [they] subsequently correct their under reaction." In other words, the short-term reward from stealth disclosure had dissipated within a period of 20 days, enabling econometric detection of the link between investors' losses and the revelation of corrective information during that window of time.

The recent stealth disclosure studies demonstrate that the window for any event study in a securities fraud action must begin upon the initial disclosure of the risk previously concealed or misrepresented by the defendant and it must extend through the moment the market fully appreciates that risk. By doing so, investors seeking redress for misstatements that caused them losses may craft an event window appropriate for the circumstances of the particular case to fit the level of stealth in the disclosures revealing the corrective information. Investors leading securities class actions may thereby promote transparency in financial disclosure and prevail over stealth financial reporting techniques that otherwise caution buyers to beware. •

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