



**James J. Park**  
Professor of Law

James Park, who teaches Business Associations and Securities Regulation, is a widely published scholar in the fields of securities regulation and corporate law. Before joining the UCLA Law faculty, he was a member of the Brooklyn Law School faculty, where he was an assistant professor from 2007-2010 and an associate professor from 2010-2013.

Upon graduating from Yale Law School, he clerked for Judge John G. Koeltl of the U.S. District Court, Southern District of New York, and then for Judge Robert A. Katzmann of the U.S. Court of Appeals for the Second Circuit. Following his clerkships, Professor Park was an associate at Wachtell, Lipton, Rosen & Katz and then served as an assistant attorney general in the Investor Protection Bureau of the New York State Attorney General's Office.

His publications have appeared in the *California Law Review*, *Duke Law Journal* and *Michigan Law Review*. His most recent publications include "Securities Class Actions and Bankrupt Companies," 111 *Michigan Law Review* 547 (2013) and "Rules, Principles, and the Competition to Enforce the Securities Laws," 100 *California Law Review* 115 (2012).



# SECURITIES CLASS ACTIONS AND BANKRUPT COMPANIES\*

James J. Park

When targeting temporary stock price declines, securities class actions often create unwarranted costs for otherwise healthy companies. Lawsuits have questionable value when directed at fluctuations that reflect market overreaction to short-term developments. However, securities class action attorneys, who receive a substantial percentage of any recovery, have significant monetary incentives to link such fluctuations to a theory of securities fraud.

INTRODUCTION

Securities class actions directed at frauds involving large public companies that suddenly filed for bankruptcy, such as Enron and WorldCom, present a powerful counterexample to this critical account. The stock prices of these companies did not just fluctuate and recover, they precipitously and completely collapsed after revelations that financial statements were overstated by billions of dollars. Though shareholders typically are wiped out in bankruptcy, Enron and WorldCom investors recovered billions of dollars from companies that essentially were frauds through securities class actions.<sup>1</sup>

In the wake of Enron and WorldCom, it has become more difficult to argue that securities class actions never serve a useful purpose for shareholders.

Though the Enron and WorldCom cases were the focus of much attention, very little is known about the subset of securities class actions involving bankrupt companies. The context of bankruptcy should be interesting to scholars of securities litigation because it includes the cases where shareholders suffer the greatest harm. The resolution of securities class actions where a bankrupt company is the issuer may shed light on the way in which context affects how parties and courts assess the merit of lawsuits.

There are two competing views as to the relationship between bankruptcy and securities fraud. Companies approaching bankruptcy have greater incentives to commit fraud in order to save the company or the jobs of managers. There thus might be a causal relationship between bankruptcy and securities fraud. On the other hand, the context of bankruptcy could lead parties and judges to more readily assume that fraud was present in bankrupt companies. This perception could reflect hindsight bias, the tendency to overestimate the predictability of events, leading to the conclusion that management knew of the danger of bankruptcy but failed to disclose it.

This study assesses the relationship between bankruptcy and securities fraud by analyzing a data set of 1,466 consolidated class actions filed from 1996 to 2004, of which 234 (approximately 16%) cases involved a company that was in bankruptcy during the pendency of the class action (“bankruptcy cases”). The study tests two hypotheses: (1) bankruptcy cases are more likely to have actual merit than cases where the issuer is not bankrupt (“non-bankruptcy cases”); and (2) bankruptcy cases are more likely to be perceived as having merit than non-bankruptcy cases, even if they do not necessarily have more merit.

The results of the study indicate stronger support for the second hypothesis than the first. The evidence is mixed with respect to whether bankruptcy cases are more likely to involve valid allegations of fraud than non-bankruptcy cases. While bankruptcy cases are somewhat more likely to involve accounting restatements than non-bankruptcy cases, they are not more likely to have other indicia of merit such as insider trading allegations, parallel Securities and Exchange Commission (SEC) actions, or a pension fund lead plaintiff. On the other hand, bankruptcy cases are more likely to succeed than non-bankruptcy cases. Bankruptcy cases are less likely to be dismissed and are more likely to result in significant settlements and settlements by third parties than non-bankruptcy cases.

Regression analysis shows that bankruptcy cases are more likely to succeed even when controlling for factors relating to the merit of the case. Logistic regressions were estimated with various measures of success as the dependent variable and various indicia of merit, case controls, and a bankruptcy variable as independent variables. For all three regressions, the bankruptcy variable was statistically significant at the 1% level.

This bankruptcy effect is evidence that bankruptcy cases are treated differently by parties and courts. The most likely explanation is that bankruptcy is a heuristic judges use to avoid dismissing cases, perhaps counteracting the tendency of judges to use heuristics to dismiss securities class actions. Though the use of the bankruptcy heuristic is troubling to the extent it reflects hindsight bias, a bankruptcy heuristic is not so problematic if securities class actions serve a more useful purpose than non-bankruptcy cases. Indeed, in bankruptcy cases, shareholder losses are permanent rather than temporary and compensation to shareholders for fraud is less likely to be a circular payment from shareholders to themselves. Judges may be influenced not only by hindsight bias but policy considerations in favoring bankruptcy cases.

This Article is divided into four parts. Part I discusses the relationship between securities fraud and bankruptcy. Part II describes the data set and provides some descriptive statistics. Part III analyzes the data set. Part IV discusses the results of the study.

Securities class actions involving bankrupt companies are of interest because there is an intuitive relationship between bankruptcy and securities fraud. There are at least two possibilities. First, there could be an actual correlation between bankruptcy and securities fraud. Managers may have greater incentive to commit fraud when a firm is heading toward bankruptcy. Second, there is no such correlation but there is a tendency to jump to unwarranted conclusions when a bankrupt company is accused of fraud, even when the company is innocent.

Bankruptcy is a context where we may see a greater incidence of fraud than with respect to solvent companies. Managers have greater incentive to commit fraud in the period leading up to bankruptcy. Alternatively, managers of companies that fall into bankruptcy could be more likely to commit fraud because of incompetence.

#### A. Actual Fraud

There are many reasons why a company finds itself in a position where it files for bankruptcy. Some developments leading to bankruptcy are the result of unavoidable macroeconomic trends, but others are at least partly the result of poor decisions by management who fail to make necessary investments and make bad strategic decisions. A new company may find that expected demand for its product never materializes. An established company can find that the market for its products and services shifts unexpectedly, leaving the company without enough revenue to cover its expenses. A company could overexpand, leaving it difficult to cover higher expenses such as financing costs.

The managers of a company have incentives to mask developments that foreshadow bankruptcy. Management could genuinely believe that the company's poor performance is an aberration that is not indicative of future trends. They might fear that if disappointing results are released, the market will overreact. Instead of reporting bad results, managers can stretch ambiguous accounting standards to report results they believe are more indicative of future trends, hoping to buy some time to save the company.

On the other hand, management can be motivated by selfish personal interest rather than a genuine belief that what they are doing is best for the company. Misrepresenting the company's performance will give managers time to exercise options or sell stock before the company's collapse. Fraud might allow a manager to keep his job while hoping that a miracle will turn the company around.

There might also be a correlation between bankruptcy and securities fraud because managers presiding over bankrupt companies are more likely to be incompetent and thus more likely to misrepresent material facts about the company. Bankruptcy may not cause fraud but the same factors that cause a company to go bankrupt can make it

more likely that there is fraud in such companies. Competent managers are more likely to avoid bankruptcy and are also more likely to avoid committing fraud. If that is the case, there would be a greater likelihood of fraud in bankrupt companies.

#### B. Perception of Fraud

Even if fraud is not more likely in bankrupt companies, there may be a perception that bankruptcy is associated with fraud. One reason for this perception is the risk of hindsight bias, the tendency to “overstate the predictability of outcomes.” Because bankruptcy is a significant and calamitous event for a public corporation, factfinders may assume that insiders with superior knowledge relative to investors must have known that bankruptcy was imminent. If that is the case, the failure to acknowledge through disclosure the risk of the developments that ultimately caused the bankruptcy will more likely be perceived as fraudulent.

To survive a motion to dismiss, any securities class action complaint alleging a violation of Rule 10b-5, must “state with particularity facts giving rise to a strong inference that the defendant acted with” scienter, that is, fraudulent intent.<sup>2</sup> This burden can be met by alleging that the defendant acted recklessly with respect to a disclosure. Recklessness has been defined by one circuit as “an extreme departure from the standards of ordinary care to the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.” Given the high subjective standard for liability in Rule 10b-5 cases, hindsight bias may not be a factor in all cases, but in a close case, hindsight bias can lead decisionmakers to conclude that in light of a company’s bankruptcy, management must have been aware of a risk that was not disclosed to investors.

The risk of hindsight bias may also influence the decision of defendants to settle cases for significant amounts. Tom Baker and Sean Griffith find through interviews of participants in the settlement process of securities class actions that D&O insurers focus on what they call “sex appeal” in negotiating the settlement amount of a securities class action.<sup>3</sup> In other words, defendants themselves are subject to hindsight bias, or are at least wary of the effects of hindsight bias, in determining the value of a claim. Bankruptcy is an obvious context that will add “sex appeal” to a case, resulting in a greater likelihood that settlements in bankruptcy cases will be significant.

## II. DATA SET AND DESCRIPTIVE STATISTICS

This Part describes the data set used in this study. The data set consists of 1,466 consolidated securities class actions filed from 1996 through 2004. During this period, there were 234 securities class actions involving companies that were in bankruptcy during the pendency of the securities class action. Bankruptcy cases thus make up 16% of the securities class actions in the data set. On average, from 1996 to 2004, there were 25 securities class actions per year involving bankrupt companies.

Table 1 summarizes the number of bankruptcy cases filed from 1996 to 2004.

Table 1. Summary Data on Number of Bankruptcy Cases in Data Set by Year (1996–2004)

Year	Number of Securities Class Actions	Number of Bankruptcy Cases	% of Securities Class Actions that were Bankruptcy Cases
1996	84	13	15.5
1997	139	17	12.2
1998	198	28	14.1
1999	173	26	15.0
2000	184	32	17.4
2001	155	38	24.5
2002	186	34	18.3
2003	163	33	20.2
2004	184	13	7.1
Total	1466	234	16.0

Consistent with findings from other studies, a high percentage of the cases in the data set settled or were dismissed. 30.8% of the cases in the data set ended in dismissal. 47.7% of the cases in the data set ended in a settlement of \$3 million or more, a common threshold used in determining whether a settlement is significant in size. A small percentage of settlements, 7.6%, involved payments from parties other than the issuer such as auditors, underwriters, and individual directors or officers.

Table 3. Summary of Case Results for Data Set (1996–2004)

Result	Number of Cases	Percent of Data Set (1,466 Observations)
Dismissed	452	30.8
Significant Settlement (\$3 million or more)	700	47.7
Third Party Settlement	112	7.6

Using the data set of securities class actions just described, this Part tests two hypotheses relating to the relationship between securities fraud and bankruptcy discussed earlier. First, securities class actions against bankrupt com-

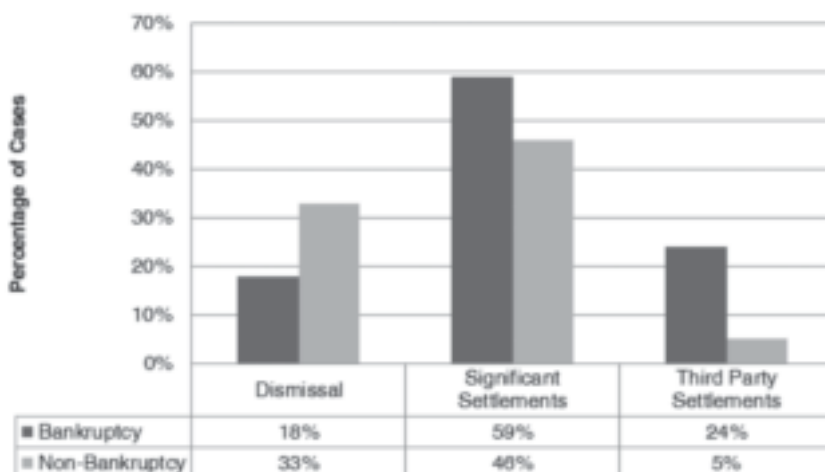
panies are more likely to have merit than securities class actions against non-bankrupt companies. Second, securities class actions do not have more merit than securities class actions against non-bankrupt companies but are perceived as having more merit. Stronger support exists for the second hypothesis than for the first.

The study found that bankruptcy cases are more likely to succeed than non-bankruptcy cases in terms of litigation results. However, the evidence is mixed with respect to whether bankruptcy cases are more likely to have indicia of merit than non-bankruptcy cases. The higher success rate of bankruptcy cases provides support for both the actual merit and perception of merit hypotheses. On the other hand, the fact that bankruptcy cases succeed without clear evidence of greater indicia of merit, indicates there is stronger support for the perception of merit hypothesis rather than the actual merit hypothesis.

1. Litigation Results

I examined whether bankruptcy cases are more likely to be successful than non-bankruptcy cases based on whether they are less likely to be dismissed, more likely to lead to a significant settlement, and more likely to result in a third party settlement. By all three measures, bankruptcy cases were more likely to end successfully than non-bankruptcy cases. A lower percentage of bankruptcy cases (18%) were dismissed than non-bankruptcy cases (33%). A higher percentage of bankruptcy cases (59%) resulted in significant settlements than non-bankruptcy cases (46%). A higher percentage of bankruptcy cases (24%) had third party settlements than non-bankruptcy cases (5%). All of these differences were statistically significant at the 1% confidence level. Figure 1 summarizes these results.

Figure 1. Litigation Results



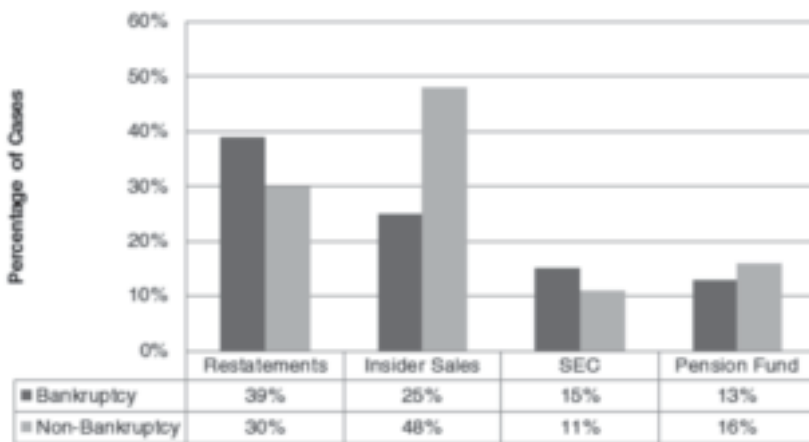


Judged by success, there is evidence supporting the two hypotheses that bankruptcy cases are more likely to have merit or are perceived to have more merit than non-bankruptcy cases. The difference appears to be most pronounced with respect to third party settlements.

2. Indicia of Merit

I next compared rates of indicia of merit between bankruptcy and non-bankruptcy cases. There was a statistically significant positive association between bankruptcy cases and restatements, though the difference was not large (39% of bankruptcy cases have an accounting restatement compared to 30% of non-bankruptcy cases). There was no statistically significant difference in the percentage of pension fund lead plaintiffs and parallel SEC actions for bankruptcy cases. There was a statistically significant association between bankruptcy cases and insider sales, but the association was negative, meaning that bankruptcy cases were less likely to have allegations of insider sales that could support a scienter requirement than non-bankruptcy cases. Figure 2 summarizes these results.

Figure 2. Indicia of Merit



Thus, because bankruptcy cases are more likely to have restatements, there is some support for the hypothesis that there is a difference in actual merit between bankruptcy and non-bankruptcy cases. However, the support is not unambiguous, suggesting that the success of bankruptcy cases may reflect perception of merit rather than actual merit.

Comparing rates of success and indicia of merit give a rough sense of whether bankruptcy cases have more merit, but fully understanding the relationship between bankruptcy and merit requires additional analysis. Though we know that bankruptcy cases are more likely to succeed than non-bankruptcy cases, simple comparisons do not explain why bankruptcy cases are more successful. Is it because they have actual

D. Logistic Regression Analysis

merit, or does the mere fact that a company is bankrupt impact the result? Many factors can influence whether a securities class action succeeds, and fully understanding the relationship between bankruptcy and the outcome of securities class actions requires analysis of additional variables that can affect the outcome of a case. Regression analysis can help us further understand why bankruptcy cases are more likely to succeed than non-bankruptcy cases.

Though we have examined litigation results and indicia of merit separately until this point, there is an obvious relationship between the success of a lawsuit and the presence of indicia of merit. A suit is more likely to succeed if it has indicia of merit such as allegations of a restatement or a pension fund lead plaintiff. Judges are less likely to grant motions to dismiss if indicia of merit are present. Moreover, parties are more likely to settle cases for significant amounts, and third parties are more likely to contribute to a settlement, if indicia of merit are present.

In addition to indicia of merit, the fact that a company is bankrupt could have an effect on the success of a lawsuit. As noted earlier, the fact of bankruptcy might itself influence the decisions of judges and parties independently from the existence of objective indicia of merit.

Simple models can be constructed that test the relationship between success and indicia of merit. A bankruptcy variable can be included to test whether the fact of bankruptcy influences whether a securities class action will be successful. If the bankruptcy variable is not statistically significant, we might conclude that bankruptcy cases are generally decided the same way as non-bankruptcy cases. If the bankruptcy variable is statistically significant, there is evidence that the fact of bankruptcy has an impact apart from the merits.

I estimated logistic regressions<sup>4</sup> with the various measures of litigation results (dismissal, significant settlements, and third party settlements) as the dependent variable and independent variables reflecting indicia of merit such as restatements, pension fund lead plaintiff, insider sales, and parallel SEC actions. I included an independent variable reflecting whether the case is a bankruptcy case. The regressions also had case controls such as the size of the company measured by total assets, whether the complaint alleged section 11 claims, length of class period, and whether the case was filed in the Second or Ninth Circuit. Variables such as the year the case was filed as well as industry of the issuer were also included.

For all three regressions, the bankruptcy variable is statistically significant at the 1% confidence level. As the perception of merit hypothesis might predict, even when controlling for indicia of merit and other factors, bankruptcy is negatively associated with dismissal and positively associated with significant settlements and third party settle-

ments. Thus, the study finds support for a “bankruptcy effect” where bankruptcy cases are more likely to succeed than non-bankruptcy cases.

By all three measures of success for securities class actions, controlling for other variables that are predictors of a successful suit, bankruptcy is associated with successful securities class actions.

The evidence indicates that bankruptcy cases are more likely to succeed than non-bankruptcy cases, though they are not likely to have greater rates of most indicia of merit. The regressions suggest that bankruptcy has an independent influence on the success of a bankruptcy case, apart from indicia of merit, indicating that judges and parties perceive bankruptcy cases as more likely to have merit. This Part assesses these results and concludes that there is stronger support for accepting the hypothesis that bankruptcy cases are perceived to have merit, than the hypothesis that bankruptcy cases are actually more meritorious. Bankruptcy is a heuristic that judges use to avoid dismissing cases.

#### IV. DISCUSSION

The bankruptcy effect likely reflects some difference relating to the merits of bankruptcy cases. The question is whether the difference is an actual difference or one of perception. On balance, there is some support for both possibilities, though the evidence more clearly supports the perception of merit hypothesis.

##### A. Bankruptcy Effect: Merits or Perception?

Perhaps the strongest evidence in support of the actual merit hypothesis is that bankruptcy cases are more likely to be associated with accounting restatements than non-bankruptcy cases. Bankruptcy cases are more likely to involve situations where final period agency costs are in play, leading to greater incidence of actual fraud than non-bankruptcy cases where the incentive to commit fraud may not be as strong. On the other hand, the difference is arguably not a large one (39% of bankruptcy case have restatements compared to 30% of non-bankruptcy cases).

The most powerful evidence against the actual merit hypothesis is that measurable indicia of merit such as allegations of insider trading, SEC proceedings, and pension fund lead plaintiffs are not present at statistically significant higher rates in bankruptcy cases. Some of these indicia, such as the presence of a pension fund lead plaintiff, are arguably stronger indicators of merit than the simple existence of a restatement. Restatements can occur by mistake and a showing of fraudulent intent is usually necessary to prevail in a securities class action. Pension funds presumably evaluate cases holistically, weighing all possible indicia of merit, both obvious and non-obvious. The presence of a credible third party who can assess the merits of a case is a stronger indicator of merit than the presence of a restatement.

The regression results, moreover, are evidence that perception of merit rather than actual merit explains the tendency of bankruptcy cases to succeed at higher rates than non-bankruptcy cases. By controlling for various indicia of merit that might explain lower dismissal rates and higher rates of significant and third party settlements, the logistic regressions isolate an independent bankruptcy effect that is evidence that the greater success of bankruptcy cases is not solely explained by the actual merits. A skeptic might respond that the regressions only control for obvious indicia of merit. There could be non-obvious measures of merit that cannot be easily scrutinized through empirical study. Such non-obvious indicia of merit could be correlated with bankruptcy and thus explain the bankruptcy effect. This argument is ultimately unconvincing without the identification of particular non-obvious indicia of merit associated with bankruptcy. Moreover, some of the obvious indicia of merit, such as the pension fund lead plaintiff variable, also reflect assessment of non-obvious indicia of merit. This study's analysis of obvious indicia of merit indicates that perception rather than actual merits is driving the success of bankruptcy cases.

#### B. The Bankruptcy Heuristic

The perception of merit hypothesis is consistent with the intuition that judges tend to decide complex cases using heuristics, or mental shortcuts. The fact of bankruptcy is likely a heuristic that influences how judges and parties perceive the merits of bankruptcy cases, leading to higher success rates for those cases relative to non-bankruptcy cases. The issuer's bankruptcy filing is known by the judges and parties in the bankruptcy cases in this data set and can thus readily serve as a way of sorting good cases from bad cases. The "bankruptcy effect" found through regression analysis is evidence that in some cases, a bankruptcy heuristic tilts the scales against dismissal or in favor of a significant settlement.

The use of bankruptcy as a heuristic for merit is somewhat different from the judging heuristics that scholars have focused on. For the most part, heuristics have been discussed as a way by which judges can dismiss cases quickly to clear their dockets. In contrast, the use of a bankruptcy heuristic is a way that judges will allow certain cases to proceed. The bankruptcy effect counteracts the tendency of judges to dispose of securities class actions at an early stage. The existence of heuristics that make it less likely that cases will be dismissed might make it more difficult to conclude that judges always discriminate against securities class actions.

The tendency to use a bankruptcy heuristic can be problematic by leading to unjust results. If judges are less likely to dismiss bankruptcy cases, parties may take this into account in settling a case. A bankruptcy provides a hint of scandal that influences parties to settle for significant amounts. Knowing this, plaintiffs could be more aggressive in bringing securities class actions against bankrupt companies so they can extort settlement payments.

On the other hand, the bankruptcy effect may not be as problematic if one believes there are stronger policy reasons for securities class actions when the issuer has filed for bankruptcy. The compensatory rationale for securities class actions is more compelling when a securities class action involves a bankrupt company. The loss by shareholders is likely significant and permanent rather than fleeting. Without a securities class action, shareholders typically receive little or nothing in bankruptcy.

Perhaps judges treat bankruptcy cases differently because they believe the policy reasons are stronger for securities class actions when they involve bankrupt rather than solvent companies. To come to this conclusion, judges need not have a full appreciation for the nuances of shareholder compensation for securities fraud but only need an intuition that the context of bankruptcy provides a better case for compensation. Judges could be dismissing these cases at lower rates because they believe that greater scrutiny of the facts through discovery is necessary to unpack the relationship between the bankruptcy and the securities fraud allegations, and that such inquiry is more likely to be worthwhile than when the case involves a healthy company. Bankruptcy cases might thus succeed because judges take on a broad view of merit that includes policy considerations and not just indicia of merit relating to the existence of fraud.

The use of bankruptcy as a heuristic is a likely explanation for the bankruptcy effect. Though hindsight bias is a factor, policy reasons might also be why bankruptcy cases are decided differently. Whatever the reason, given the ambiguity of the concept of securities fraud, we can expect judges and parties to rely on context in calculating the value of these cases.

**T**his study began by advancing two hypotheses relating to the difference between bankruptcy and non-bankruptcy cases. The first was that there is a difference in actual merits consistent with the view that fraud is more likely in a last period context. The second was that there was no actual difference in merits but that bankruptcy cases are perceived to have more merit than non-bankruptcy cases. Stronger support was found for the second hypothesis. Even when controlling for various indicia of merit, there is a bankruptcy effect that makes it more likely that these cases will succeed. This finding likely reflects a form of hindsight bias on the part of judges who decide these cases.

## CONCLUSION

This study has implications for understanding the role of securities class actions. Perhaps the most compelling cases brought by investors involve companies that fall into bankruptcy in the wake of a fraud. The study of bankruptcy cases shows that judges use heuristics not only to dismiss securities class actions but also to deny motions to dismiss. This tendency could reflect hindsight bias as well as the belief that there is a core set of cases where there is greater consensus as to the utility of securities class actions. Certainly, context matters in the way that judges and parties assess the merit of securities class actions.



- \* James J. Park is a Professor of Law at UCLA School of Law. This article is an abridged version of James J. Park, *Securities Class Actions and Bankrupt Companies*, 111 MICH. L. REV. 547 (2013).
1. See *In re Enron Corp. Sec., Derivative & “ERISA” Litig.*, No. MDL-1446, 2008 WL 4178151 (S.D. Tex. Sept. 8, 2008) (approving \$7 billion settlement fund including settlements by gatekeepers); *In re WorldCom, Inc. Sec. Litig.*, No. 02 Civ. 3288(DLC), 2005 WL 2319118 (S.D.N.Y. Sept. 21, 2005) (approving \$6 billion in settlements including settlements by gatekeepers).
  2. 15 U.S.C. § 78u-4(b)(2) (2006).
  3. Tom Baker & Sean J. Griffith, *How the Merits Matter: Directors’ and Officers’ Insurance and Securities Settlements*, 157 U. PA. L. REV. 755, 787 (2009).
  4. A logistic regression is a regression where the dependent variable is dichotomous, that is, can only take on the value of 0 or 1.