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Short sales and class-action lawsuits

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ABSTRACT

Gande and Lewis (2009) show class-action lawsuit filings are anticipated by investors. In this paper, we examine short-selling activity surrounding lawsuit filings and find that short activity surges in the days before the filing. However, short-selling activity remains significantly high until a few days after the filing. We also find some evidence that both pre- and post-filing short activity can be used to predict the outcome of the filing. In particular, we find that, after controlling for a variety of firm-specific factors, short activity during the filing period increases the likelihood that the lawsuit eventually generates money for the plaintiff.

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1. Introduction

Researchers examining stock returns for firms that face litigation generally find significant negative wealth effects as the initiation of litigation typically results in negative abnormal returns (Ellert, 1976; Karpoff and Lott, 1993; Bhagat, Brickley, and Coles, 1994; Bizjak and Coles, 1995; Bhagat, Bizjak, and Coles, 1998). While prior research examining the effect of litigation on stock prices is broad, little attention has been given to securities-related class-action litigation. Recently, Gande and Lewis (2009) examine the effect of class-action lawsuits on stock prices during the periods

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immediately before and immediately after the lawsuit filing and show that these lawsuits are generally anticipated by investors as returns become negative during the pre-filing period.[1]

In this study, we examine short-selling activity during the period surrounding the initiation of class-action lawsuit filings. The motivation to do so is twofold. On one hand, researchers suggest that short sellers are sophisticated investors and are informed about future stock price movements (Diamond and Verrecchia, 1987; Senchack and Starks, 1993; Aitken, Frino, McCorry, and Swan, 1998; Dechow, Hutton, Meulbroek, and Sloan, 2001; Desai, Ramesh, Thiagarajan, and Balachandran, 2002; Christophe, Ferri, and Angel, 2004; Boehmer, Jones, and Zhang, 2008; Diether, Lee, and Werner, 2009). Engelberg, Reed, and Ringgenberg (2012) show that the information contained in short sales is driven by short sellers' superior ability to process already-public information instead of their ability to predict the disclosure of the information. Similar to Daske, Richardson, and Tuna (2005), Engelberg, Reed, and Ringgenberg (2012) show that short selling substantially increases *after* the announcement of firm-specific events. These studies indicate that short activity is expected to remain at relatively normal levels during the period immediately before the class-action lawsuit filing and increase substantially during the period immediately after the filing.

On the other hand, recent reports made available by the Securities and Exchange Commission (SEC) document several allegations of abusive trading practices as law firms reportedly provided information about the timing of filing dates about upcoming class-action lawsuits to hedge funds and other investors.[2,3] These allegations appear to have merit given the findings in Gande and Lewis (2009). Plaintiff law firms might have a financial incentive to leak information to financial markets prior to lawsuit filings to create pessimistic trading activity and improve the chances that the lawsuit might be settled. Under this assumption, short selling is expected to increase during the period immediately before the lawsuit filing. Given that research indicates that short sellers are informed investors, investigating short activity surrounding class-action lawsuits might also provide insight into the flow of both private and public information into the market (Miller, 1977; Jones and Lamont, 2002), which can have important regulatory implications.[4]

In this study, we use a sample of securities-related class-action lawsuits that were filed because of violations of either the Securities Act of 1933 or the Securities and Exchange Act of 1934. We partition the filed lawsuits into two groups. The first group of lawsuits consists of those that were awarded money for the plaintiff in court or were eventually settled outside of court, which, for brevity, we denote as "successful" lawsuits. The second group of lawsuits consists of those that did not win money for the plaintiff in court or those that were dismissed from court. We denote this second group of lawsuits as "unsuccessful" lawsuits. Our univariate event study shows short activity markedly increases during the few days prior to the filing date. Short turnover (short volume as a percentage of shares outstanding) is 1.35% for the average stock two days before the lawsuit filing. The average daily short turnover across our sample time period is 0.4%, indicating that short turnover is 3.4 times higher than normal during the period prior to the lawsuit filing. Further, short turnover remains at least twice as high as normal until four days after the filing.

Our multivariate results indicate that, after controlling for other factors that influence short activity, short turnover is abnormally high during the five days prior to the class-action lawsuit filing date. These

[1] Other studies that look at class-action lawsuits attempt to predict which firms have a higher probability of being named a defendant in a securities class-action lawsuit based on such variables as CEO turnover and insider trading (Niehaus and Roth, 1999; Iqbal, Sherry, and Wang, 2007), restatement of earnings, share turnover, and market capitalization (Field, Lowry, and Shu, 2005), or the exercising of executive stock options (Bradley, Cline, and Lian, 2010).

[2] http://www.sec.gov/comments/s7-08-08/s70808-461.pdf.

[3] http://www.sec.gov/rules/other/4-476/washlegal052203.pdf.

[4] Regulation Fair Disclosure (Reg FD), which was implemented on August 15, 2000 and made effective on October 23, 2000, restricts the selective disclosure of information by publicly traded companies and other issuers to only a particular set of investors. Other studies examine the effectiveness of insider trading restrictions (Seyhun, 1992) and show that the restrictions might decrease the amount of trading activity but do not decrease the trading profits of the insiders. However, law firms filing class-action lawsuits against publicly traded companies do not fall under the jurisdiction of Reg FD. In addition, another regulation was instituted by Congress. In 1995, Congress passed the Private Securities Litigation Reform Act to discourage meritless securities fraud class actions. Johnson, Nelson, and Pritchard (2007) show that Congress accomplished its goal to restrict fraudulent class action behavior. However, Helland (2006) shows that meritless class actions still exist and only the top 25% of settlements affect the reputation of the firm.

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