

# ANTICIPATING EVENT STUDIES IN UK AND EUROPEAN SHAREHOLDER CLASS ACTIONS

*Universally accepted by US courts, event studies are likely to become important in connecting data with facts for courts on this side of the Atlantic too*



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**W**orldwide, corporate upheaval continues. Government support is being withdrawn despite the effects of the pandemic and the availability of historically cheap finance is ebbing away. For some companies, declining liquidity may lead to insolvency. Simultaneously, the role of the auditor is being scrutinised like never before and incidents and allegations of audit failure continue to hit the headlines.

In such circumstances, securities litigation is likely to boom and more companies will need to confront the issue head on. The UK and the wider European legal community are alive with the prospect of a surge in shareholder class actions. Legal developments on both sides of the Channel have made such litigation more practical for prospective claimants.

This is a well-trodden path in the US. Over the past 20 years or more, the US courts have decided a litany of claims of shareholder harm and an extensive body of legal precedents has developed.

## Assessing Shareholder Loss

Shareholders may claim that they have suffered loss, but how can the existence and size of such losses be assessed? One way is to turn to fundamental valuation techniques based on discounted cash flows, valuation ratios or sums of the parts to attempt to discern the effect of particular events. The downside to such techniques, particularly in a contentious situation, is that they are subjective and fraught with the potential for material disagreement. For example, how would they be applied to Tesla where there is little consensus on the basis for the company's valuation?

There is, however, an objective approach that relies on public information and follows rather more defined techniques: the event study. An event study is used to identify the existence of shareholder harm caused by a disclosure and provide a means of measuring any associated losses. Universally accepted by US courts, event studies are likely to become an important feature of the

European shareholder class action landscape. The key to such cases, however, often lies in the ability to connect data with facts and to communicate this connection to the court. Rarely is this ability more important than when fulfilling the need to demonstrate the relationship between observed market data and the publication of corporate facts.

## Why Perform an Event Study?

An event study is essentially a statistical analysis of the behaviour of the price of a publicly traded financial instrument, such as an ordinary share of a listed company, in response to the disclosure of information relevant to the company. This disclosure — whether by the issuer of that share or a third party such as a newspaper — represents the 'event' in question. In circumstances where the news relates to a past failure by the company fully to inform the market of a situation, the event is referred to as a 'corrective disclosure'.

The core of an event study is the assessment of how the price of the security moves compared to an appropriate market-based benchmark, on a daily basis. Differences in the underlying relationship represent abnormal returns. In practice, since the price behaviour of the subject company's securities will naturally deviate from that of the benchmark, the analysis will reveal a range of positive and negative abnormal returns absent any company-specific events. The task of the preparer of an event study is to determine whether the timing of the event(s) being studied coincides with an abnormal return of a magnitude that is statistically significant — i.e. would be sufficiently unlikely to have occurred simply by chance.

When a statistically significant abnormal return is identified, it is essential to confirm whether the event being studied is the only cause. This is achieved through scouring news sources to identify other potentially relevant company-specific events. If found, the existence of an effect may be determined by analysis of trends in the intra-day trading for that share. Where there is a



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discernible impact, the additional news is a 'confounding event'. The challenge is, if possible, to apportion the abnormal return between the event being studied and the confounding event. If the time between the two events is short or both occur outside trading hours, it is likely to be extremely difficult to untangle objectively the effects of the two events in question.

### **What to Look Out for as Event Studies Appear in the UK and EU**

The deployment of Event Studies in litigation has been extensively tested by the US legal system; there are many precedents on which litigants can rely. As UK and EU member state courts deal with shareholder class actions, it will be fascinating to see the extent of the alignment with, or divergence from, the US approach. By way of example, we will touch on three of the more important aspects here: ways of assessing market efficiency; the selection of appropriate event windows; and the mechanics of measuring losses suffered by shareholders.

#### **Market Efficiency**

The requirement for market efficiency is fundamental to the assumption of a connection between the event and movements in the share price. If the share is trading in an efficient market, it is assumed that its price takes into account all of the publicly available information. It follows, then, that when a disclosure is made, the price of the share swiftly adjusts to reflect the impact of the information contained in that disclosure.

In the US system, the five features that indicate an efficient market are known as the 'Cammmer factors', established in a case of that name. These factors will inevitably be tested in the UK and EU over the coming months and years. In practice, however, such factors are likely to be present for shares traded on the major stock markets within these jurisdictions.

The Cammer factors include the requirement for sufficiency of trading volume, market capitalisation and analyst coverage of the relevant shares. Furthermore, there must be market-makers such as institutional investors that provide a mechanism for the incorporation of information into the share price. Finally, there must be an empirical observation of a cause and effect relationship between corporate news and a reaction in the share price.

#### **The Event Window**

The Event Window should cover the period from when the disclosure takes place until the point at which

the share price fully reflects the new information. In practice, share prices may take anywhere between seconds and days to fully react to the newly disclosed information and may initially over-react, so there is no objective test to identify when this process is complete. For example, a rapid drop in a share price in the minutes or hours immediately after a disclosure can be followed by a more gradual recovery in the following days. The event window is important because it forms a necessary input for identifying potential shareholder losses.

#### **Mechanics of Measuring Shareholder Losses**

The approach to measuring any actual or hypothetical losses associated with the event depends upon the unique circumstances of the case. The aim, however, is to identify where a claimant suffers a loss because of either paying too much for their shares or realising less than they would have on the sale of those shares. The buying and selling prices of the shares may be self-evident when a shareholder buys and sells their entire holding of the shares. However, where they trade more actively, buying and selling portions of their holdings, the base price for calculating losses is less clear. In practice, approaches can use an average price or track the share holdings on either a 'first-in, first-out' (FIFO) or 'last-in, first-out' (LIFO) basis.

#### **Conclusion**

We've only scratched the surface of a practice that has developed over decades in the US. The path taken in the UK and EU will start to resolve when event studies are tested in UK our courts. What is clear is that, in light of the uncertainty, the most successful litigants and counsel will be those who are best informed and prepared when the claims land.