REVIEW OF CORPORATE LITIGATION: INSTITUTIONAL BACKGROUND, THEORY, AND EMPIRICAL FINDINGS

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ABSTRACT

This paper reviews research on corporate litigation with a focus on securities litigation, as it has been the most common type of corporate litigation in recent years. The legal and economics literature explain why settlements are more likely to take place in corporate lawsuits by analyzing the role of economic incentives, information asymmetry, agency cost, and transaction cost in the litigation process and settlement decisions. A large body of empirical research in multiple disciplines (law, economics, management, finance, and accounting, etc.) document evidence consistent with the theoretical explanations.

INTRODUCTION

This paper provides a review of the literature on corporate litigation with a focus on securities litigation. This topic is worthy of review since securities litigation against public companies has long been viewed as an important disciplinary mechanism of the US capital market (Coffee, 2006; Donelson, McInnis, Mergenthaler, and Yong, 2016; Helland 2006; Huang, Rui, Shen, and Tian, 2017; Peng & Roell, 2008; Romano, 1991). According to Cornerstone Research (2017), the litigation exposure of US public companies to class action filings increased for a fifth consecutive year in 2016 and reached 3.9% of all US public companies, suggesting that approximately one in 25 companies listed on US exchanges was the subject of a class action.[2]

There is a large body of theoretical and empirical research in multiple disciplines regarding corporate litigation, yet it lacks a systematic review. A related paper by Arena and Ferris (2017) provides a review of litigation in the field of corporate finance. They examine studies of the estimation of litigation risk, litigation costs, stock reaction to lawsuit announcements, the litigation effects on corporate policies, and litigation outcomes. This paper differs from Arena and Ferris (2017) in two ways: First, it reviews the litigation literature in multiple disciplines, including law, economics, management, finance, and accounting; hence it

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[2] As a litigation consulting firm, Cornerstone Research collaborates with the Stanford University Law School on the Securities Class Action Clearinghouse (SCAC) database, which is widely used in the empirical study of litigation. Cornerstone Research issues review and analysis reports on securities class action annually.

will provide a broader perspective on corporate litigation. Second, it surveys not only empirical research but also theoretical research on corporate litigation, providing a systematic review on the theoretical framework of corporate litigation.

The remainder of this paper is organized as follows: Section 2 introduces the institutional background of securities litigation in the US and the procedure of a typical securities class action. Section 3 provides a literature review on the theoretical work of litigation and settlement decisions. Section 4 reviews the empirical research regarding the effects of the Private Securities Litigation Reform Act of 1995 (PSLRA), including the litigation effects on corporate financial policy and accounting reporting. Section 5 concludes.

INSTITUTIONAL BACKGROUND OF SECURITIES LITIGATION IN THE US

The federal securities laws in the US have two major fraud enforcement methods. The first one is the public enforcement, i.e., formal Securities and Exchange Commission (SEC) enforcement actions, where the SEC files civil charges or recommends that the Department of Justice file criminal charges in a case. The second is private enforcement, i.e., securities class action suits, where private attorneys, on behalf of damaged shareholders, file civil actions against the firm and/or its management (Helland, 2006). Under the Securities Act of 1933 and the Securities Exchange Act of 1934, all public firms in the United States are exposed to the risk of security class action lawsuits. The private enforcement has long been considered more likely to penalize corporate misconduct than formal SEC enforcement actions (Coffee, 2006; Huang et al., 2017; Peng & Roell, 2008). In this paper, securities litigation risk specifically refers to the risk of securities class action lawsuits, because it has grown to become a major source of risk and cost for corporations (Arena, 2018).

Securities Class Action and the Private Securities Litigation Reform Act

A securities class action is a case brought on behalf of a group of people who purchased the securities of a particular company during a specified period of time (known as "the class period") (Cornerstone Research, 2017a). The plaintiffs are the purchasers of the securities during the class period. The securities class action generally begins after significant ‘‘bad news’’ is announced by the firm that causes a sharp stock price decline. Depending on the availability of material facts, plaintiffs usually file the suit within a few days to a few months of the announcement. The common complaint contains allegations that the company and/or its officers and directors have violated federal or state securities laws. A typical statement alleges that the firm has made false and/or misleading statements and/or failed to disclose material information. The class period is the time period over which these misstatements have led to inflated stock prices, and this period usually ends on the ‘‘bad news’’ announcement day.

Securities class actions generally proceed without identifying all of the plaintiffs and their corresponding losses. Shareholder losses are estimated using the sequence of share prices during the class period, the number of shares traded during the class period, and models of the holding periods of investors (Niehaus & Roth, 1999). A large proportion of securities class actions are concentrated in certain industries including computers, electronics, biotechnology, and pharmaceuticals (Ali & Kallapur, 2001; Choi & Thompson 2006; Francis, Philbrick, and Schipper, 1994).

Once securities class actions are filed, there are two general outcomes: dismissal or settlement. Very few class actions proceed to trial. From 1997 to 2015, 43 percent of cases were dismissed, 50 percent were settled, and 7 percent are ongoing with less than 1 percent of the filings going to trial (Cornerstone, 2017a). The amount of the class action settlement reflects the outcome of negotiations between the defendants' managers and the plaintiffs' attorneys, which may vary significantly from the estimated damages. During the past decade, the average estimated damages for all shareholders per year was $3,353 million, while the median settlement only accounts for 2.37 percent of that average (Cornerstone, 2017b).

The current securities litigation environment in the US is defined by the PSLRA, passed to deter frivolous securities litigation (Donelson, McInnis, and Mergenthaler, 2012a). The PSLRA adopts heightened pleading standards, making it more difficult to file a lawsuit without specific allegations about the nature of the fraud. In addition, it establishes a safe harbor for the voluntary disclosure of financial projections and other forward-looking information, and prevents plaintiffs from gaining access to the defendant firm's nonpublic documents while a motion to dismiss is pending (called "stay of discovery") (Choi & Thompson, 2006; Johnson, Kasznik, and Nelson, 2001, Johnson, Nelson, and Pritchard, 2007). [3] The PSLRA also requires courts to appoint lead plaintiffs under the presumption that investors with the largest financial interest in the relief are the most capable representative of the potential class members.

Procedure and Timeline of Securities Class Action

In a typical securities class action, when multiple actions are filed during a short time window, the court consolidates all cases and appoints one lead plaintiff to represent the entire class. The lead plaintiff chooses attorneys to be the lead counsel for this class action. A defendant firm typically files a motion to dismiss shortly after the lawsuit is filed. A motion to dismiss argues that, even if all of the facts alleged in the complaint were true, those facts would not be sufficient to give rise to liability under the securities law (Federman & Sherwood, 2013). If the court grants the motion to dismiss with prejudice, the plaintiff does not have the opportunity to file another complaint. The case is over, and the plaintiff will not get any recovery. If the court grants the defendant's first motion to dismiss without prejudice, the plaintiff is allowed to amend and file a second, consolidated complaint. If the court denies the motion to dismiss, the plaintiffs have the right to obtain access to the defendant firm's nonpublic documents, which is known as the discovery stage (Klausner, Hegland, and Goforth, 2013).

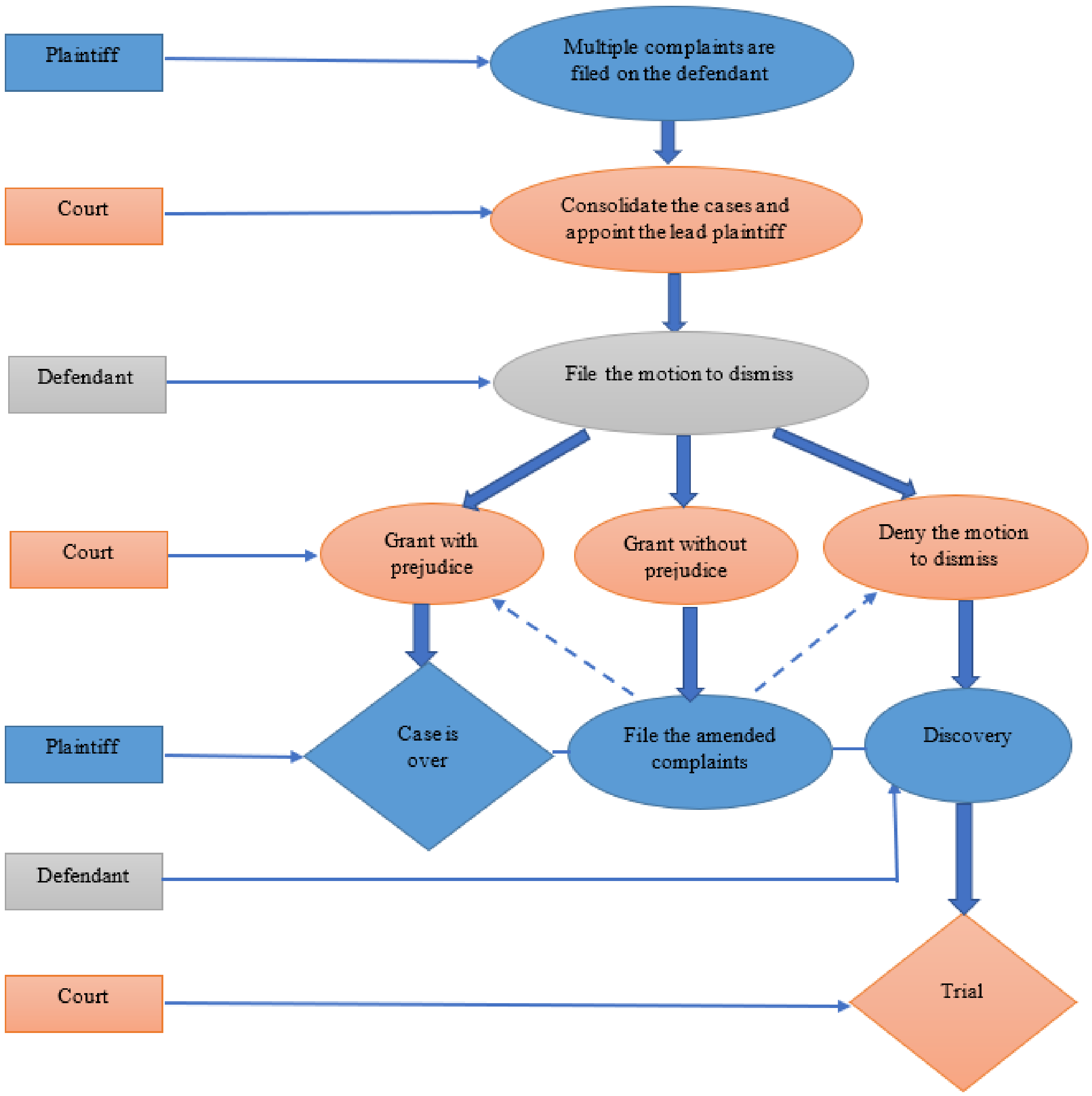
3 See next section "procedure and timeline of securities class action" for the association between the motion to dismiss stage and the discovery stage.

At the discovery stage, the plaintiff has the right to demand the defendant providing documentary evidence concerning the facts at issue.[4] In addition, the plaintiff has the right to require officers of the company, any experts or other third parties, to sit for depositions (Federman & Sherwood, 2013). The costs of litigation increase substantially in the discovery process, and the plaintiff will have a much greater chance for recovery. Thus, it is critical to the litigants whether a motion to dismiss is granted or denied. Defendants typically wait to see whether their initial motion to dismiss is successful. If it is not, they settle the case soon after the motion to dismiss has been denied, but before the actual discovery has begun. For the period of 2000 to 2010, over half of the securities class actions ended before discovery and even before a second complaint was filed (Klausner et al., 2013).

Once the discovery process is completed, class plaintiffs may seek class certification. By that time, the case officially becomes a securities fraud class action. Obviously, the defendants will face much pressure to settle the case to avoid liability if the case goes to trial (Federman & Sherwood, 2013). The settlement process generally includes four steps: negotiating a settlement, seeking preliminary court approval, obtaining final court approval, and the claims administration process. Figure 1 shows the process of a typical securities class action. Given that settlement or dismissal can occur at any stage before the trial is announced, they are not included in the figure.

[4] Scope of discovery see 29 CRF section 18.51 “Discovery scope and limits” (https://www.law.cornell.edu/cfr/text/29/18.51, retrieved June 21, 2021).

Figure 1. Litigation Procedure of a Typical Securities Class Action



THEORETICAL ANALYSIS OF LITIGATION AND SETTLEMENT DECISIONS

The legal and economics literature provide well-developed theories on litigation and settlement decisions. The economic analysis of litigation began with Landes (1971) and Gould (1973). They assessed the economic incentives underlying the process of litigation. Their major argument is that when two risk-averse parties become involved in a conflict that has an uncertain outcome, they could eliminate uncertainty and settle the conflict by a riskless transfer of wealth. This risk-aversion effect provides an explanation for why settlements are more likely to take place in lawsuits (Shavell, 1982). The litigants make decisions about settling by comparing the economic value of the offer to the costs of going to trial.

Subsequently, P'ng (1983) and Bebchuk (1984) offered bargaining models of strategic settlement decisions in the presence of information asymmetries. Pretrial bargaining is described as a game played in the shadow of the law (Cooter, Marks, and Mnookin, 1982). Intuitively, the defendant has information that is not available to the plaintiff, but the plaintiff has no information to which the defendant does not have access. The litigants' strategies are interdependent under such incomplete information. From the perspective of the bargaining model, settlement occurs only if the amount of the settlement is greater than the plaintiff's expected return from trial and less than the defendant's legal costs. Getting to the discovery stage in the litigation process increases the probability of settlement because the information asymmetry between the parties is expected to be reduced.

Miller (1987) analyzed agency problems in litigation. He argues that the standard model of litigation outlined in prior studies is incomplete in settings where the plaintiffs and their attorney have potentially conflicting interests in the lawsuit. Potential conflicts could arise during the evaluation of settlement offers. The attorney may often call for accepting the offer, even though going to trial might be a better option for the plaintiff. It seems the law gives the ultimate power of decision-making to the plaintiff, yet the effective control is actually in the hands of the attorney, particularly for cases like class actions and shareholder derivative suits.

Engelmann and Cornell (1988) raised the transaction cost hypothesis to explain litigation costs. While Miller (1987) assumed that the only cost of litigation is attorney fees, Engelmann and Cornell (1988) argue that attorney fees are only a small fraction of the litigation cost. In addition to the direct cost of attorney fees, other litigation costs come from three sources: the risk of follow-on suits by other plaintiffs, the risk of court-imposed constraints that limit the defendant firm's future behavior, and rising transaction costs. These substantial, indirect litigation costs contribute to the plaintiff's incentive to sue and the defendant's incentive to settle cases. In a normal business process, a firm enters contracts with its trading partners like customers, investors, suppliers, and employees. When the firm becomes a defendant in a major lawsuit, the cost of establishing contracts with those trading partners rises. Given that a lawsuit may damage the defendant's reputation and disrupt its cash flow due to the potential payment of attorney fees and settlements, trading partners may be more cautious, demanding more detailed provisions in written contracts and requiring the inclusion of previously unwritten agreements.

EMPIRICAL RESEARCH ON SECURITIES CLASS ACTION LITIGATION

This section reviews the empirical research on the merits of lawsuits, the effect of the PSLRA, and the litigation effect on corporate finance and accounting reporting.

Merits of Lawsuits and the PSLRA

Empirical research in earlier years focused on the merits of lawsuits; for example, whether settlement amounts increase with the strength of the case (i.e., Alexander, 1991;

Romano, 1991). Based on an analysis of IPO firms in the high-tech industry, Alexander (1991) finds that settlement behavior does not correspond to the prediction of the economic model. It is structural incentives, including the transaction and agency costs, procedural and substantive rules of law, and the existence of insurance, rather than merits of the case, that create a strong tendency toward settlement decisions. Romano (1991) asserts that the effectiveness of securities litigation is as a mechanism to align managers' incentives with shareholder interests, and he documents that securities litigation is a weak instrument of corporate governance. While litigation is supposed to impose personal liabilities on corporate directors and officers, the individual defendant contributes almost no personal expenditure because the funds for settlements are provided by indemnification rights and the directors' and officers' (D&O) liability insurance.

The passage of PSLRA has generated extensive empirical study on securities class actions. Most of the analyses examine whether non-meritorious suits have been blocked by the PSLRA and how that affects the census of suits and recovery. Earlier studies like Johnson et al. (2000) and Ali and Kallapur (2001) investigated share price effects associated with the passage of the PSLRA. Some studies report that filing and settlements in the post-PSLRA period include a higher percentage of meritorious litigation. For example, Johnson et al. (2007) explored the role of merit-related factors (measured by accounting restatements) in the filing and resolution of lawsuits for the high-tech industry and report an increased relationship between accounting restatements and the filing/settlement of lawsuits in the post-PSLRA period. Choi (2006) examined whether the PSLRA selectively eliminates meritorious litigation. Among other things, he finds that, in the post-PSLRA period, (1) IPO firms with smaller offerings are less likely to be the target of a securities class action since such firms provide less potential damage recovery; and (2) companies engaged in fraud without publicly announced hard evidence (i.e., accounting restatements or SEC enforcement) are less likely to face a securities class action. Pritchard, Choi, and Nelson (2009) found similar evidence. Johnson et al. (2001) evaluated the safe harbor provision of the PSLRA. They compare how firms from computer hardware, software, and pharmaceutical industries changed their voluntary disclosure of forward-looking information between the pre- and post-PSLRA period. They report that firms increased the frequency of their disclosure in the post-PSLRA period, particularly among firms with higher *ex ante* litigation risk.

Another stream of existing studies examines the lead plaintiff provision of the PSLRA, which addresses the agency problem of the plaintiff's attorney. The litigation agency cost arises when the plaintiff's attorneys have interests that diverge from shareholder interests and may lead to high settlement rates or low settlement amounts (Choi, 2004; Cox & Thomas, 2006; Niehaus & Roth, 1999; Romano, 1991). The PSLRA requires that in a securities class action, the lead plaintiff should be the investor with the largest financial interest; such a plaintiff is expected to actively supervise the class action, thus mitigating the litigation agency costs (Choi & Thompson, 2006). Under the act, the lead plaintiff has the power to select and fire the class counsel. The PSLRA also has restrictions on attorney fees. Cox and Thomas (2006) analyzed the costs and benefits for institutional investors being the lead plaintiff since only institutional investors have a large enough stake in the class actions. They find that the presence of an institutional lead plaintiff improves the settlement size. Cheng, Huang, Li, and Lobo (2010) further document the institutional investors' monitoring effectiveness through securities litigation. Securities class actions with institutional investors as lead plaintiffs are more likely to survive the motion to dismiss stage and get larger settlement amounts than securities class actions with individual lead plaintiffs. Moreover, defendant firms with institutional lead plaintiffs experience greater improvement in corporate governance than defendant firms with individual lead plaintiffs.

Litigation Effect on Corporate Behaviors and Outcomes

The financial literature provides abundant evidence of the litigation effect on corporate activities, financial policies, and outcomes. Firms with higher litigation risk underprice their IPOs as a form of insurance, and increased underpricing lowers expected litigation costs (Lowry & Shu, 2002). The increased litigation risk in an industry leads firms to adjust their financial policy, i.e., choosing higher leverage through stock repurchase or using more operating leases (Crane, 2011). When the exogenous risk in legal liability increases, firms tend to undertake a period of aggressive growth by acquiring large and unrelated businesses to diversify firm risk (Gormley & Matsa, 2011). Firms with greater exposure to securities litigation significantly increase the level of cash holdings and reduce capital expenditures in anticipation of future settlements and other related costs (Arena & Julio, 2015; McTier & Wald, 2011).

In addition to the negative stock market reactions to corporate lawsuits (i.e., Deng, Willis, and Xu, 2014; Ettredge, Huang, and Zhang, 2016; Gande & Lewis, 2009; Griffin, Grundfest, and Perino, 2004; Kellogg, 1984), litigation risk raises the defendant firm's cost of capital. Before a lawsuit filing, firms with higher litigation risk have lower credit ratings, pay higher yields, and are less likely to rely on debt financing (Arena, 2018). After a class action is filed, defendant firms pay higher loan spreads and up-front charges, restricted by more financial covenants, and are more likely to experience a collateral requirement (Deng et al., 2014). At the time of the lawsuit resolution, settlement costs have an additional effect on firm credit quality. For firms facing larger settlement amounts and less available cash, they will experience declined credit ratings and increased yield spreads (Arena, 2018).

Litigation Effect on Accounting Reporting and Disclosure

Litigation risk explains why US accounting standards contain rule-based characteristics (Donelson et al., 2012a, 2016). The extant accounting literature mainly explores the relationships between litigation risk and corporate disclosure, earnings management, accounting conservatism, corporate governance, and executive compensation.

There is a long line of research examining the relationship between securities litigation risk and corporate disclosure. Skinner (1994) proposes that managers have an incentive to preempt large negative earnings surprises in order to reduce the probability of litigation and the magnitude of estimated damages. While Francis et al. (1994) and Skinner (1997) do not demonstrate consistent evidence as to whether voluntary disclosure deters or triggers litigation risk, Field, Lowry, and Shu (2005) overcome the endogeneity issue between securities litigation and corporate disclosure and find some evidence that disclosure deters litigation. Using a new measure to capture the timeliness of earnings news, Donelson, McInnis, Mergenthaler, and Young (2012b) also document that earlier revelation of bad earnings news lowers the likelihood of litigation. Cao and Naravanamoorthy (2011) measure litigation risk by the D&O liability insurance premiums and study the effect of litigation risk on management earnings forecasts. They find that managers facing higher *ex ante* litigation risk are more likely to issue a bad news earnings forecast. While Johnson et al. (2001) find a significant increase in corporate voluntary disclosure following the passage of the PSLRA, particularly for firms with high *ex ante* litigation risk, Rogers and Van Buskirk (2009) examined changes in defendant firms' disclosure policies and document that defendant firms decrease the magnitude and precision of disclosures subsequent to the lawsuits.

Palmrose and Scholz (2004) examined the role of accounting items in bringing and resolving litigation and find that core/revenue restatements are positively associated with securities litigation, while non-core accounting restatements are not. DuCharme, Malatesta, and Sefcik (2004) analyzed the interaction between stock issuances, abnormal accruals, and lawsuits. Abnormal working capital accruals around stock offers are significantly positively correlated with the incidence of class action lawsuits and settlement amounts. Gong, Louis, and Sun (2008) document a positive association between stock-for-stock acquirers' pre-merger abnormal accruals and post-merger announcement lawsuits. Chalmers, Naiker, and Navissi (2012) provide evidence of significantly lower earnings quality (measured by earnings overstatement) in both the pre- and post-PSLRA periods for defendant firms.

Litigation induces both conditional and unconditional accounting conservatism (Qiang, 2007). In a study examining the association of accounting conservatism with subsequent initiation of lawsuits, Ettredge, Huang, and Zhang (2016) find that defendant firms with greater degrees of conditional conservatism gain more favorable consequences in both litigation occurrence and outcomes.

Laux (2010) analyzed how an increase in liability exposure impacts the board of directors' decisions regarding monitoring and CEO incentive pay. On the one hand, directors can increase the level of oversight to prevent accounting manipulation, which is beneficial to shareholders. On the other hand, directors can reduce the link between CEO pay and firm performance to weaken the CEO's incentive in accounting manipulation, which can hamper shareholder interest. Dai et al. (2014) investigate the relationship between pay-for-performance sensitivity and firm risk under the exogenous class action litigation setting in which executives are found innocent in litigation. Their findings suggest that boards should decrease equity compensation and increase cash compensation when firms are initially sued and revert back when the uncertainty associated with litigation is later resolved.

CONCLUSION

Securities litigation is an important private enforcement mechanism in the US to penalize corporate misconduct. Securities class action lawsuits are the most common type of securities litigation faced by US firms in recent years. Theoretical studies in earlier years explored the role of economic incentive, information asymmetry, agency cost, and transaction cost in explaining the litigation process and settlement decisions. Empirical studies have provided consistent evidence that securities litigation exposure is costly to corporations and have long lasting effects on the corporate activities and financial policies of defendant firms. In addition, research in recent years has examined the spillover effect of litigation risk on industry peers and the negative effects of litigation on firm stakeholders including investors, debtholders, and auditors.

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