

Accepted Manuscript

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Kuntara Pukthuanthong, Harry Turtle, Thomas Walker, Jun Wang

PII: S0929-1199(17)30320-6
DOI: doi: [10.1016/j.jcorpfin.2017.05.008](https://doi.org/10.1016/j.jcorpfin.2017.05.008)
Reference: CORFIN 1202

To appear in: *Journal of Corporate Finance*

Received date: 22 May 2015
Revised date: 18 May 2017
Accepted date: 18 May 2017

Please cite this article as: Kuntara Pukthuanthong, Harry Turtle, Thomas Walker, Jun Wang, Litigation risk and institutional monitoring, *Journal of Corporate Finance* (2016), doi: [10.1016/j.jcorpfin.2017.05.008](https://doi.org/10.1016/j.jcorpfin.2017.05.008)

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Litigation Risk and Institutional Monitoring

Kuntara Pukthuanthong
University of Missouri

Harry Turtle
Colorado State University

Thomas Walker
Concordia University

Jun Wang*
University of Western Ontario

This version: November 28, 2016

Abstract

According to the existing literature, institutional investors have a significant impact on the litigation risk of publicly traded companies. This should be particularly true after the Private Securities Litigation Reform Act (PSLRA) of 1995 that encourages institutional investors to serve as lead plaintiffs in securities class actions. Using a large sample of securities class action lawsuits, we distinguish between different types of institutional investors based on their investment horizon and ownership structure and find that both factors significantly affect a firm's litigation risk. Short-term institutional investors are more likely to monitor firms through ex-post litigation, whereas long-term institutional investors prefer to monitor firms internally. Further, we document a nonlinear relation between the stock ownership of the largest institutional investor and a firm's litigation risk. In particular, as measures of long-term (short-term) ownership increase, the likelihood of litigation declines (increases). In summary, shareholder litigation may be an effective external monitoring device for short-term investors that serves as a substitute for internal corporate governance mechanisms.

JEL Classification: G34; K41

Keywords: Shareholder Litigation; Corporate Governance; Institutional Investors.

*Pukthuanthong: pukthuanthongk@missouri.edu; Turtle: Harry.Turtle@colostate.edu; Walker: twalker@jmsb.concordia.ca; Wang: jun.wang@uwo.ca. Wang would like to acknowledge financial support from the Social Sciences and Humanities Research Council of Canada (SSHRC), Canadian Business Ethics Research Network (CBERN), PhD Winter Research Meeting, 2013, Financial Management Association Annual Meeting, 2013, Paris Financial Management Association Annual Meeting, 2015. We thank Douglas Cumming for his comments. Wang would like to acknowledge financial support from the Social Sciences and Humanities Research Council of Canada (SSHRC).

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