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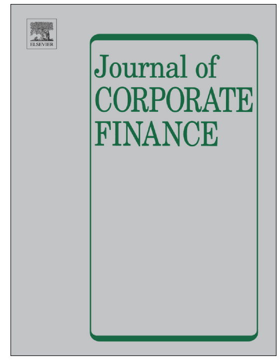

Litigation risk and institutional monitoring

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Litigation Risk and Institutional Monitoring

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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.

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