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Settlement agreement types of federal corporate prosecution in the U.S. and their impact on shareholder wealth☆

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ABSTRACT

This paper analyzes the shareholder wealth effects of corporate prosecution settlements in the U.S. from 2001 to 2014. We focus on the relative monetary size of the settlement and on deferred prosecution and non-prosecution agreements in contrast to traditional plea agreements. The results show that the settlement of criminal prosecution leads to positive shareholder wealth effects, which may be due to the resolution of any remaining uncertainty with respect to the total settlement amount and lower than expected settlement costs. Stockholders generally view the announcement of plea agreements more positively than the announcement of deferred prosecution and non-prosecution agreements. The likelihood of a certain agreement type is strongly dependent on the crime committed. Moreover, larger firms with better board-related governance structures that have not been criminally prosecuted prior to the settlement are more likely to avoid a criminal conviction.

1. Introduction

Federal prosecution of corporations has been rising and is becoming of increasingly higher concern for companies conducting business in the U.S. During the last decade, the U.S. Department of Justice (DOJ) prosecuted more firms than ever before (Alexander & Cohen, 2015). The majority of wrongdoings relate to violations of the Foreign Corrupt Practices Act (FCPA) as well as antitrust, fraud, and environmental offenses. One of the most prominent corporate prosecutions in recent years is connected to the Deepwater Horizon oil spill of 2010, which caused one of the largest environmental catastrophes in U.S. history. BP, a British oil and gas company and the ultimate platform operator, subsequently settled criminal and civil claims and paid penalties of 4 billion U.S. dollars in 2012 and an additional 18.5 billion U.S. dollars in 2015. A more recent example of federal corporate prosecution is the emissions scandal of Volkswagen, a German car manufacturer. While civil charges have been resolved in June 2016 with a payment of 15.3 billion U.S. dollars, a settlement with respect to criminal charges is still outstanding. In the case of Horizon Lines LLC, a U.S. shipping company acquired in 2015 by Matson Inc., the firm pleaded guilty to price fixing in 2011 and agreed to pay a fine of 45 million U.S. dollars. Even though the absolute fine is small compared to the monetary penalties of BP or Volkswagen, it amounted to approximately 34% of the company's 2010 year end market value, thereby representing an existential threat to the company.

The development of corporate prosecution in the U.S. not only shows a rise in the number of cases during the past decade but also a change in settlements' characteristics (Uhlmann, 2013). Until 2003, settlements were predominantly reached through plea bargaining. A plea bargain or plea agreement (PA) is an agreement between prosecutor and defendant. A key component is the admission of guilt and the defendant's final conviction. Charges need to be filed and the agreement is dependent on court approval. Since 2004, however, two other types of agreements have been used intensely by the

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DOJ: deferred prosecution agreements (DPA) and non-prosecution agreements (NPA). In contrast to PAs, these "pretrial diversions" do not require the admission of guilt or a conviction. By avoiding a conviction a company may deter costly collateral consequences like debarment or exclusion from government contracts. On the other hand, DPAs and NPAs, on average, include more provisions regarding compliance programs or corporate monitors (Alexander & Cohen, 2015).

Settlements are supposed to reduce the costs associated with lengthy court trials, speed up the resolution of pending litigation, and are frequently used for corporate prosecutions. However, prior research so far mainly focuses on specific types of lawsuits as well as the announcement of the filing of charges and largely neglects the settlements' valuation effects. For the announcement of criminal or civil lawsuit filings, previous studies generally find negative stock market reactions for the defendant company (e.g., Karpoff, Lee, & Martin, 2008). With regard to the settlement announcement the picture is less clear, as some studies find negative effects (e.g., Karpoff et al., 2008), while others observe wealth gains (e.g., Bhagat, Brickley, & Coles, 1994). Yet, a comparison of these studies is difficult, as the samples are comparatively heterogeneous, based on the type of lawsuit they investigate. Moreover, there is no empirical evidence on the shareholder wealth effects of DPA and NPA announcements. Some argue that particularly large corporations are treated preferentially and suffer comparatively less when using pretrial diversions, such as DPAs and NPAs (e.g., Bourjaily, 2015; Garrett, 2011; Markoff, 2012; Uhlmann, 2013). Moreover, compared to PAs, the collateral consequences of pretrial diversions are potentially less severe, as there is no legal conviction. This may lead to investors valuing the use of pretrial diversions positively. Therefore, empirically analyzing the current application of agreements and their impact on shareholder wealth with a focus on the use of DPAs and NPAs offers new information on the ongoing debate on how the government should prosecute corporations. In this context, particular attention will be given to the role of corporate governance and whether the DOJ uses different agreement types depending on the firm's governance structures. Since empirical analyses so far are scarce (e.g., Alexander & Cohen, 2015; Markoff, 2012), this effort presents a novel contribution to the literature.

This study addresses this research gap in multiple ways. First, the prosecution of stock-listed corporations and the differential characteristics of DPAs, NPAs, and PAs are analyzed through descriptive statistics. Second, the general influence of prosecution settlements on shareholder wealth is analyzed. Settlement announcement may resolve any remaining uncertainty with respect to the outcome of pending litigation and the total settlement amount a firm has to pay. In this context, if payments are smaller than investors initially anticipated, settlements may lead to positive valuation effects for the firms. Third, we determine the drivers of the observed stock market reaction and specifically test whether DPAs and NPAs are perceived as more beneficial by investors compared to PAs, controlling for multiple case-specific, company-specific, and governance-specific factors. Fourth, we empirically test why the DOJ uses different types of settlements by identifying factors that influence the likelihood of DPAs and NPAs versus more traditional PAs. Finally, factors influencing the settlement amount are determined. To undertake these analyses, a comprehensive database containing 100 plea, 64 deferred prosecution, and 63 non-prosecution agreements is constructed and analyzed for the time period from 2001 to 2014.

The rest of the paper is structured as follows. Section 2 provides a brief background on corporate prosecution in the U.S. Section 3 offers a literature review, while Section 4 develops the hypotheses. Section 5 presents the sample selection procedure, the descriptive statistics, and the empirical approach. Section 6 documents the empirical results and Section 7 summarizes and concludes the paper.

2. Background on corporate prosecution in the U.S.

Criminal liability of corporations was established in the U.S. in 1909 by the Supreme Court (New York Central R. Co. v. United States, 1909). Firms are potentially criminally liable for crimes committed by their employees acting within the scope of their employment with an intent to benefit the firm (Arlen, 2011). Yet, until the 1970s firms were rarely prosecuted. During the 1990s prosecution intensified, the majority of cases being settled through PAs with very few cases going to trial. Beginning in the early 2000s, the landscape of corporate prosecution changed dramatically with an increasing number of cases prosecuted by the DOJ and a marked increase in the use of pretrial diversions in the form of DPAs and NPAs. Pretrial diversions as a means to resolve corporate prosecutions first emerged in the 1990s (Alexander & Cohen, 2015) and in contrast to PAs these settlements do not involve the admission of guilt or the defendant's conviction. Charges against the company will be dropped or not brought to trial if the firm complies to the agreement's terms. The increase in pretrial diversions partially reflects the DOJ's concerns about excessive collateral consequences of criminal convictions for corporations and may, at least to a certain extent, be also motivated by the practical consideration of expedience. Furthermore, the agreements are frequently used as a monitoring tool to influence corporate culture and the way firms conduct their business (Uhlmann, 2013).

Pretrial diversions themselves are no novel means of law enforcement and were applied to individual defendants, mainly to avoid an excessive impact for first time offenders and to efficiently allocate public resources (Bourjaily, 2015). However, their use to resolve corporate prosecutions is controversial (Alexander & Cohen, 2015). The concerns mainly center on the diminished punitive and deterring effect of pretrial diversions, the lack of judicial oversight, and the DOJ's involvement in corporate affairs through comprehensive compliance programs. With a DPA, charges are filed and a court must approve the waiver of the stature of limitations while prosecution is deferred. Following the deferral, a judicial review is conducted. This review, however, appears to be a formality, as no court has rejected a DPA so far. NPAs, in contrast, are contracts between the government and a corporate defendant that can be concluded without direct court involvement (Uhlmann, 2013). Some commentators argue that PAs are better suited to resolve corporate prosecution since they have a higher deterrence effect and can also be used to implement compliance programs, while the threat of going out of business is small (e.g., Arlen, 2011; Bourjaily, 2015; Markoff, 2012).

Fig. 1 shows the typical succession of events for federal corporate prosecutions that conclude with a settlement. It begins with an offense that usually lasts for a certain time period. At some point, either during the offense period or following it, the crime becomes public knowledge. Depending on the crime committed, this may be through different means, such as environmental damages, investigative journalistic reporting, or financial restatements. Typically, shortly after information about potentially illegal behavior is available investigations of the responsible U.S. federal agency (e.g., the Federal Bureau of Investigation (FBI), the Drug Enforcement Administration (DEA), the Securities and Exchange Commission (SEC), or the Environmental Protection Agency (EPA)) begin. If the investigated offenses are criminally chargeable, they are referred to the DOJ, which alone is authorized to undertake prosecution under criminal federal law. Corporate crime is thereby practically exclusively treated on the federal level and therefore prosecuted by the U.S. DOJ. Parallel to criminal prosecutions civil lawsuits are often pursued by the investigating agency.[1] During the criminal prosecution

[1] For example the DOJ and the SEC frequently bring parallel criminal and civil charges (Giudice, 2011).