



A global analysis of corporate litigation risk and costs

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ARTICLE INFO

Article history:

Received 8 August 2017

Received in revised form 5 May 2018

Accepted 10 May 2018

JEL classification:

G15

K20

K41

Keywords:

International corporate finance

Corporate litigation

International law

ABSTRACT

We analyze a unique hand-collected international sample of 475 corporate lawsuits involving 361 publicly-traded defendant firms headquartered in 16 developed countries to explore how country factors influence litigation risk, equity market value, lawsuit outcomes, and settlement costs. Unlike U.S.-focused studies, we do not find a significant relation between stock turnover, equity performance, and the probability of litigation. Defendant firms headquartered in civil law countries or countries with less efficient judiciary systems face lower litigation risk and costs as well as less share price decline at filing. Countries whose courts are less independent demonstrate a significant bias against foreign defendant firms.

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1. Introduction

Although various studies analyze the effect of U.S. corporate lawsuits on shareholder value (e.g., Bhagat et al., 1994; Gande and Lewis, 2009) and extensive research examines the effect of litigation risk on corporate behaviors (e.g., Lowry and Shu, 2002; DuCharme et al., 2004; Arena and Julio, 2015), the law and finance literature lacks an empirical analysis of the international corporate litigation environment. In this study we address this omission by analyzing a unique hand-collected sample of global lawsuits to explore how national legal systems, practices, and courts influence the corporate legal experience during litigation.

Our study advances the law and financial economics literature by exploring for the first time the financial implication of global litigation. As corporate globalization progresses to establish itself as a major driver of economic growth, cross-border lawsuits have become widespread along with their relevance to the financial health of multinational companies. Our study provides novel evidence regarding how different institutional and legal characteristics across countries affect the corporate litigation environment. Specifically, we explore the effect of firm characteristics and country legal practices on the likelihood of litigation, the types

of lawsuits filed, the market reaction to lawsuit filings, litigation outcomes, and settlement costs.

The dataset we use for our analysis consists of 482 corporate lawsuits filed between 1999 and 2008 against 361 publicly-traded firms headquartered in 16 different developed countries. We terminate our sample in 2008 to allow sufficient time for the suits to resolve and allow us to analyze final outcomes. Unlike other studies of corporate lawsuits, our sample is not restricted to class action securities litigation, but consists of a variety of lawsuits including patent, antitrust, fraud and labor lawsuits. Thus, our study is the first to analyze the effect of litigation not only across a number of countries, but also for different lawsuit types. We develop seven different hypotheses to motivate our empirical work. These hypotheses focus around the triggers for litigation and the national determinants of litigation risk, the nature of the capital market's response to a lawsuit filing, and the effect of court honesty and efficiency on litigation outcomes.

We obtain a number of interesting and useful findings from our empirical analysis. Globally, security lawsuits are less common than in the U.S. due to the lack of a foreign analogue to the SEC's Rule 10b-5. This SEC rule provides a right of action to investors against companies and directors for material misstatements that affect the secondary trading of securities. Foreign corporate law does not allow the initiation of class action lawsuits as easily as U.S. corporate law. When a lawsuit is initiated, the resulting settlement costs faced by defendant firms are also lower, providing less incentive to plaintiffs to initiate litigation (Armour et al., 2009). Unlike

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studies of U.S. lawsuits, we find that our international sample of lawsuits is not dominated by security class action lawsuits. Indeed, only 13.6% of our sample consists of these kinds of lawsuits. Further, we observe that equity underperformance for these foreign firms does not significantly increase the probability of a lawsuit. We also show that the announcement of a lawsuit filing against a non-U.S. firm effects its share price less negatively than it does for U.S. firms.

Consistent with studies showing a different level of legal protection between civil law and common law system countries (e.g., La Porta et al., 1998), we find that differences in national institutional settings have a significant effect on litigation risk and the stock price reaction observed at the time of the lawsuit announcement. Specifically, we find that corporate litigation risk is lower for firms residing in civil law countries and countries with a less developed judiciary and legal system. The stock market reaction surrounding the announcement of a lawsuit filing is significantly more negative for defendant firms when the filing occurs in a common law country, in countries with a stronger rule of law, or countries with greater legal system integrity.

Finally, we determine that the legal system and the judiciary quality of the country in which the lawsuit is filed have a significant effect on the lawsuit's outcome. Everything else constant, defendant firms are more likely to lose their lawsuit or settle for higher amounts when the lawsuit is brought in countries with a common law heritage or a stronger rule of law. Further, we find that courts are more likely to rule against foreign defendant firms except in those countries where the judiciary has a tradition of independence and integrity. [Bhattacharya et al. \(2007\)](#) present evidence suggesting that U.S. firms have a home court advantage in U.S. federal courts. We find that this domestic bias in corporate lawsuits is a worldwide phenomenon, but can be mitigated by country-specific court impartiality.

We organize the remainder of this study as follows. Section 2 provides the development and discussion of our seven hypotheses which motivates our subsequent empirical analysis. Section 3 outlines our sample construction process and variable measurement. Section 4 provides summary statistics and an initial univariate analysis. Section 5 contains our examination of global litigation risk. Section 6 reports the results from our event study analysis while Section 7 describes our findings concerning litigation outcomes and costs. Section 8 presents a set of robustness tests while Section 9 concludes with a summary and a brief discussion.

2. Hypotheses development and discussion

U.S. federal civil procedure rules greatly facilitate the initiation of corporate lawsuits by various classes of stakeholders. Security class action lawsuits triggered by a decline in the stock price are extremely common in the U.S. and often result in significant settlement expenses for the defendant firm ([Arena and Julio, 2015](#)). Such lawsuits, however, occur less frequently outside the U.S. ([Armour et al., 2009](#)). [Buschkin \(2005\)](#) notes that most foreign countries disapprove of the U.S. class action device as a way to punish firms. Indeed she explains that in many countries the legal system believes that governments, not private litigants, should regulate corporate conduct. [Sherman \(2002\)](#) claims that most other countries see the U.S. class action lawsuit as a “Pandora’s box that they want to avoid opening.” Thus, given the reluctance of other nations to encourage or even permit corporate class action lawsuits, a decline in share price should be less of a trigger for litigation outside the U.S. Therefore, we hypothesize:

Hypothesis 1. Stock underperformance and stock turnover do not significantly increase litigation risk for non-U.S. firms.

[Buschkin \(2005\)](#) argues that the large size of the damages awarded to plaintiffs in U.S. class action lawsuits offends “foreign notions of public policy”. That is because most civil law countries believe that it is the role of the state to control corporate behavior. Lawsuits are seen as a mechanism to compensate victims for their losses, rather than punishing or deterring some corporate activity. U.S. law, and common law in general, believes that the threat of large civil damages resulting from lawsuits brought by private litigants can deter illegal or undesired activity. It can therefore serve as a substitute for public policy. Because of this fundamental difference in how class action litigation is viewed, we contend that firms are less likely to be sued in civil law countries. We hypothesize:

Hypothesis 2. Litigation risk is less for firms residing in civil law versus common law countries, everything else constant.

[Wallace \(1998\)](#) describes how judicial corruption damages capital markets since it “increases the cost of running businesses, distorts public expenditures, and deters foreign investors.” It also compromises the ability of firms to contract since enforcement becomes problematic. This inability to contract is of special concern to investors and other suppliers of corporate capital who rely on contracting to protect their rights and ensure a rate of return ([La Porta et al., 1997](#); [Denis and McConnell, 2003](#)). Lawsuits filed in corrupt courts are unlikely to be successful because the judges are not impartial.

If, however, the judiciary reflects high standards of ethical and professional behavior and practice, then firms can reasonably anticipate their contracts will be enforced. Judicial independence from political coercion makes it more likely for the rule of law to hold and for a stronger enforcement of corporate contracts. Further, there is likely to be a higher level of legal protection available to shareholders and other investors. Consequently, investors should anticipate greater success if they decide to file suit in such an environment. Therefore, we hypothesize:

Hypothesis 3. Litigation risk is greater for firms residing in countries with an independent and non-corrupt judiciary, everything else constant.

The filing of a lawsuit is a negative event for a firm. If the suit is found to be meritorious, then the firm faces direct litigation costs in the form of a settlement or damage awards. Indirect costs, such as the opportunity cost of management’s time and reputational damage, are also significant for most lawsuits ([Karpoff and Lott et al., 1999](#)). [Bhagat et al. \(1994\)](#); [Bizjak and Coles \(1995\)](#), and [Bhagat et al. \(1998\)](#) examine the wealth effects of inter-firm lawsuits in the U.S. and discover that defendant firms experience a statistically significant negative price reaction at the time of the lawsuit filing. [Gande and Lewis \(2009\)](#) report significant negative stock price reactions to shareholder-initiated class action lawsuits in the U.S. Defendant firms outside the U.S. should also experience adverse movements in their share price upon announcement of a lawsuit filing because of the uncertainty regarding the size of the possible penalties. The reaction of these defendants, however, is likely to be less than that of their U.S. counterparts. This is due to more frequent judicial dismissals and smaller settlement amounts for lawsuits outside the U.S. as reported by [West \(2001\)](#) and [Armour et al \(2009\)](#). We hypothesize the following concerning the global reaction to the filing of a lawsuit:

Hypothesis 4. A defendant firm’s stock price significantly declines at the announcement of a lawsuit filing.

[Beck et al. \(2003\)](#) explain how there is a difference between common and civil law regarding the importance they attach to private property rights relative to the rights of the state. They contend that common law has evolved to protect private property against the state and thus is associated with a robust set of shareholder

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