2006

Management and Market Reactions to Litigation: Do Shareholders Win When the Company Loses?

Terence Lau
University of Dayton, tlau01@udayton.edu

tested plans, the percentage growth in options also declines. So, on one level, boards appear to hear shareholders' message. However, CEO pay does not decline; only its growth rate declines. Among the 40 most contested options plans, the value of new option grants still grew by almost 40 percent. This is considerably less than the 140 percent growth in options that sparked the initial shareholder revolts, but some might argue that the level of board restraint is less than what many shareholders had hoped.

A limitation of Martin and Thomas' study is that it provides only a one-year snapshot at a time when the stock market was growing rapidly. Perhaps in a post-techbubble, post-Enron scandal world, shareholder reaction to dilutive plans might be stronger and apply to more plans. The average no vote was 19 percent in 1998 among the 156 plans for which Martin and Thomas have complete data. By 2004, the average no vote had reached 25 percent, and seven plans (versus four in 1998) were defeated outright. Today, the effect of shareholder anger might also translate into greater consequences in the CEO's next pay period. Recent regulations such as Sarbanes-Oxley might strengthen boards seeking to respond to shareholder criticism.

The main message of Martin and Thomas is that, while some types of stock option plans hurt shareholders, boards seek to correct their mistakes by subsequently reducing the growth rate of CEO pay. Shareholders need to be most concerned about option plans that go only to executives and dilute the stock more than 5 percent. Boards and CEOs should be aware that proposing such plans will negatively affect share prices in the short run and later draw protest votes. Boards will feel pressure to respond by holding the line on future CEO pay. If Martin and Thomas are right, perhaps boards are finally starting to get the message.

Source: Martin, K. J., & Thomas, R. S. 2005. When is enough, enough? Market reaction to highly dilutive stock option plans and the subsequent impact on CEO compensation. *Journal of Corporate Finance*, 11: 61–83.

Management and Market Reactions to Litigation: Do Shareholders Win When the Company Loses?

Research Brief by Terence J. Lau, Assistant Professor of Management, University of Dayton

Litigation against companies has existed as long as businesses have competed. From the Dodge brothers' lawsuit compelling Ford to declare a dividend to shareholders, to more recent examples such as patent litigation against Blackberry-maker Research in Motion and product liability claims against Merck for its Vioxx drug, stock markets have reacted to these lawsuits. Regardless of who the plaintiffs are (e.g., government entities, other firms, individuals) and whether or not the actions stem from civil or criminal law, markets adjust a company's stock price for the effect of litigation on company profitability. Indeed, numerous studies conclude that the filing of a lawsuit against a company is always accompanied by a negative reaction from stock markets.

To most executives, the idea that litigation is bad for business and that settling is better than going to trial may seem common sense. The explosive popularity of alternative dispute resolution (ADR) to resolve business disputes is attributable to the desire of most companies to avoid public disclosure and expensive litigation. Conventional wisdom suggests that companies avoid litigation because of the length of time involved, the high cost, the public disclosure of intellectual property or embarrassing secrets, and the destruction it wreaks on existing business relationships. If this wisdom is true, then stock markets should react positively when a company short-circuits the litigation process and settles. In essence, settling should be seen as a sign that management is removing a distraction to achieving company goals.

However, research finds that companies that settle litigation actually tend to be punished by stock markets. A new study by Bruce Haslem of Florida State University about how markets react to settlements and judgments was designed to find out why. Moreover, prior research also suggests that when companies refuse to settle and instead take on litigation, they are rewarded by markets, *even when they lose the case*. Why these two seemingly contradictory phenomena occur has tremendously important significance for senior management. Haslem's theory, and one largely supported by his findings, is that agency costs are the explanation. In essence, he argues that conventional thinking is flawed because it assumes that the plaintiff and defendant in a case always act optimally and with perfect information—settlement occurs when defendants believe that their chances of losing at trial are greater than winning. Haslem's study has much to teach us about the inherent conflicts that exist when managers act selfishly instead of in the shareholder's best interests.

But first, it is important to understand that the term "agency costs" is used to describe the tension that exists between managers (the agents) and shareholders (the principals). Shareholders always seek to maximize share appreciation. Managers, on the other hand, are often motivated by various perks (e.g., non-cash compensation), career advancement, and executing a strategy. Sometimes, managers also want to avoid information becoming public to shareholders. This "skeleton in the closet" information may reflect poor decisions on behalf of management, and if made public, could result in adverse employment actions against the manager. To the extent that managers take corporate actions based on these factors (other than share price appreciation), agency costs exist.

Haslem theorizes that the more a manager stands to lose in litigation and wants to keep certain information from becoming public, the harsher the market reaction to a settlement announcement. As a corollary to this first question, Haslem also explores whether there is a relationship between the existence of information a manager wants to keep private and the speed at which settlement is reached following litigation. If such a relationship exists, it suggests that shareholders should be suspicious when litigation is quickly settled by a company. In these situations, active shareholders may wish to seek further explanation from management about the nature of the information being hidden.

Haslem conducted his research using a computerized database of federal district court filings. The cases he studied were filed between 1994 and 1998, and covered suits based on antitrust, breach of contract, product liability, labor, patent infringement, and derivative shareholder actions. He only studied firms that were publicly listed, and eliminated suits that later consolidated into class-action suits, involved a foreign parent company, or could not be tracked to a final determination. All told, Haslem examined 965 specific events, making his study the most comprehensive thus far. In addition, Haslem examined specific characteristics of defendant firms. These characteristics included number of shareholders, percentage of shares held by insiders, free cash flow, CEO salary, managerial options, number of directors, percentage of inside directors, director compensation, and whether the CEO and board chairperson were the same individual.

Haslem's study resulted in several important findings. First, he found a significant negative reaction to the settlement announcement of litigation. This finding confirms the results of previous research, but on a much larger scale. Haslem also found that firms that chose settlement continued to under-perform in the market for up to one year following settlement. Conversely, Haslem found that the average market reaction to a judgment, regardless of whether the defendant company won or lost the case, was *positive*. Haslem believes that the explanation is simple. If firms have high agency costs, shareholders would prefer that a case advance all the way to trial. Even if the companies lose, shareholders gain valuable information about the quality of management.

Another key finding of the study is that the timing of a settlement is very much affected by the strength of two key measures of corporate governance—board composition and the ownership structure of the firm. Settlements tend to occur sooner when companies have a higher percentage of insiders on their boards, have larger boards, and have the same person serving as both CEO and board chair. Haslem believes that these factors paint the management of these firms as being less subject to the monitoring of their actions. Consequently, these firms prefer to settle litigation earlier to protect management—ostensibly because they have more to hide.

Finally, Haslem concludes that there are certain aspects of agency costs that can indicate how markets react to certain settlements. If management holds a large portion of a firm's equity, if more of a firm's equity is held by large shareholders, or if the firm pays dividends and aligns management compensation with shareholders by granting stock options, then markets tend to react more positively to settlements. On the other hand, if the CEO is also the board chair, if there are high fixed salaries for the CEO, and if the firm has higher levels of free cash flow, then market reaction to settlements is more negative. These results largely confirm that agency costs play a major role in determining market reaction to settlements. When management is seen as more transparent to shareholders, markets tend to be less punishing compared to when management is considered to be more opaque.

Haslem's research raises some important questions. Clearly, the most immediate impact of his research is to demonstrate that financial markets are very concerned about agency costs when a firm settles litigation. Agency problems may result in management making poor decisions on settlement, including settling too early—or for too much money—in order to protect their own personal interests. Beyond this, Haslem's study once again raises questions about the duties of company management. Under state law, officers and directors owe a fiduciary duty to the corporation itself and to the shareholders of the corporation. Haslem's research indicates that the market is skeptical, at best, about whether this duty is practiced on a practical level. The fiduciary duty of officers and directors must be real, not theoretical, to provide markets with the confidence needed to make assessments of a company's performance. Furthermore, Haslem's study indicates the need for legislators, once again, to consider extending the fiduciary duty to all management, and not just officers and directors.

Corporate governance and shareholder activism have enjoyed a renaissance in the wake of Enron, Tyco, and other high-profile corporate scandals. The malfeasance of a few has brought newfound attention to the motivations of management—especially senior management—everywhere. This study sheds new light on the tension between management and shareholders' interests when resolving litigation. For management, the lesson from Haslem's research is straightforward. The markets are sophisticated enough to realize that quick settlements are often a sign of bad management seeking to restrain information from becoming public. When management settles lawsuits for reasons other than an optimal outcome based on costs and benefit, management should realize that markets and shareholders are watching their moves closely. Settlement may end litigation, but it also may be only the beginning when it comes to tough questions that management has to answer.

Source: Haslem, B. 2005. Managerial opportunism during corporate litigation. *Journal of Finance*, 60(4): 2013–2041.

Power Plays: Can Power Dynamics Explain Changes in Corporate Governance Practices?

Research Brief by Kathleen Rehbein, Associate Professor of Management, Marquette University

Today, companies are undergoing important corporate governance transformations. Much of this effort is in response to the passage of Sarbanes-Oxley, one of the most comprehensive and stringent pieces of legislation in the history of corporate governance. Additional restrictions have been imposed by NASDAQ and the NYSE that parallel Sarbanes-Oxley. These restrictions require company boards to maintain a majority of independent directors, hold meetings without management present, and develop codes of ethics. Firms are also aware of the increased consequences for ethical lapses given the severe sentencing of the CEOs of large companies such as Tyco and WorldCom. Lastly, institutional activists continue to pressure firms to change their corporate governance practices.