U.S. class action lawsuits targeting foreign firms: The country spillover effect☆

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Abstract

We find negative price reactions among non-sued U.S.-listed foreign firms to filings of U.S. shareholder lawsuits targeting firms from their home country. This country spillover effect is stronger for lawsuits, especially accounting-related ones, targeting firms from more poorly-governed countries. We also document a stronger country spillover effect for a recent wave of U.S. lawsuits targeting Chinese issuers than for other standalone litigation. Finally, a foreign firm's price reaction to lawsuits targeting its country peers predicts its chance of being sued in the future. Our findings are consistent with investors updating a foreign firm's litigation risk upon lawsuits targeting its country peers.

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1. Introduction

The U.S. legal system allows shareholders to file class action lawsuits to penalize corporate misconduct and deter potential miscreants. Private litigation has long been considered more likely to penalize corporate misconduct than formal SEC enforcement actions.2 Existing studies find that stock prices of sued firms respond negatively to such lawsuits, due to both substantial direct expenses such as attorney fees and potential monetary penalties and indirect costs including damages to corporate reputation (e.g. Romano (1991), Field et al. (2005), Karpoff and Lott (1993), Karpoff et al. (2008a), Karpoff et al. (2008b)). Furthermore, Gande and Lewis (2009) argue that many lawsuits are filed in response to events likely affecting firms sharing similar attributes (for example, industry peers), and these lawsuits signal that comparable firms are susceptible to similar lawsuits. They find negative stock price reactions among non-sued industry peers around the filing of lawsuits, supporting the spillover effect of lawsuits.

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2 For instance, Coffee (2006) finds that 2.1–2.8% of U.S. firms were subject to private litigation lawsuits between 1995 and 2005, and also demonstrates that the penalties imposed by private litigation are greater than those imposed by SEC enforcements.

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Recently, the literature has begun to analyze U.S. shareholder lawsuits targeting foreign firms, due to the growing number of foreign firms listed in the U.S. and the substantial increase in litigations targeting them in recent years. Gande and Miller (2012) document a severe loss in market valuation for sued foreign firms around the lawsuit filing date. One distinct feature of foreign issuers is the influence of home country institutions on their practices and thus litigation risk. There are many reasons why investors would expect foreign firms from the same home country to share similar practices. For instance, foreign issuers located in a given country are subject to similar local regulations and disclosure requirements, share similar corporate cultures, and tend to have similar accounting and auditing practices. As such, when assessing litigation risk of a foreign issuer, investors would take into account its home country’s institutional environment and shared practices of its home-country peers.

When U.S. shareholders sue a cross-listed firm from a particular foreign country, the credibility of other firms from that country may also be called into question, which, in turn, could lead to expectations of similar lawsuits against these peer firms. We explore this home country or shared macro governance channel of litigation spillovers by examining a broad sample of 274 U.S. shareholder lawsuits targeting foreign firms cross-listed in the U.S. during the period January 1996 to June 2012. We first examine price reactions of sued firms to confirm the information content of lawsuit filings. Stock prices of sued firms start to react negatively around two weeks prior to the lawsuit filing, especially within the week of filing announcement (daily abnormal returns ranging between −1% and −2%), and such negative price reactions cease on the date following the lawsuit filing.3 The pattern of abnormal returns is almost identical to that documented in Gande and Miller (2012). Given the clear evidence of pre-filing price reactions and the lack of post-filing drifts, we measure a firm’s overall price reaction to a lawsuit over two event windows, a long [−10, +1] one and a short [−3, +1] one.

Turning to non-sued foreign firms, we rely on the difference in price reactions between the sued firms’ home-country peers and other foreign firms to infer potential country spillovers of litigations.4 Consistent with the return pattern of the sued firms, we observe economically significant differences in daily abnormal returns between two groups of foreign firms only in the pre-announcement window, especially within one week of the filing. The average difference in cumulative abnormal returns (CARs) is \(-0.84\% \) (\(-0.50\%\)) over the \([-10, +1]\) \([-3, +1]\) window around the litigation filing date, indicating an economically meaningful loss of market value for the sued firms’ country peers, even compared with the lawsuit targets, which on average have a CAR of \(-10.06\% \) (\(-6.52\%\)) over the same window. Country spillovers of lawsuits are robust to the control of lawsuit industry spillovers, other firm characteristics related to litigation risk, and various country fixed effects in a multivariate regression analysis.

The evidence of country spillovers of lawsuits is consistent with investors updating a foreign firm’s litigation risk upon its country peers’ lawsuits. One important implication of such litigation risk updating mechanism is that more significant spillovers to country peers are expected for lawsuits filed in response to events likely more relevant for most firms in a country. We explore this lawsuit ‘systematicness’ implication with three additional tests. The first test relates lawsuit country spillovers to the home country macro-governance strength. Misconduct of foreign issuers from a poorly governed country could be viewed by investors as representative of their country peers’ practices, as the institutional and regulatory discipline is weak or even non-existent, whereas similar events concerning foreign issuers from a well governed country may be perceived as relatively idiosyncratic. We indeed find that lawsuit country spillovers decrease in the home country macro-governance strength as measured by the World Bank’s Governance Index (GI). In fact, when classifying home countries of foreign issuers into two groups based on the median value of GI, we find that country spillovers exist only for lawsuits filed against foreign firms from the poorly-governed countries.

Next we focus on lawsuits targeting foreign firms from poorly-governed countries (i.e., those with below-median GI), and test whether country spillovers are stronger for accounting-related lawsuits. Firms in the same country tend to share more similar accounting practices than operational ones due to common accounting standards and regulatory measures. Hence for firms from countries with weak macro governance, accused accounting misconduct would be viewed as more systematic among their country peers. Consistent with this prediction, we find that accounting lawsuits are associated with stronger country spillovers than other lawsuits.

Our third test to explore the effect of lawsuit “systematicness” on country spillovers is a clinical study of the January 2010–June 2012 episode of U.S. shareholder lawsuits targeting Chinese issuers, especially those listed in the U.S. through reverse mergers (CRMs). We conjecture that investors tend to consider alleged corporate misconduct as more representative of country peer firms’ practices when they observe a series of litigations against firms from the same country. As a result, country spillovers should be stronger for lawsuits in an episode than those relatively standalone ones. Empirical findings confirm this prediction and thus provide further support for the litigation-risk updating explanation of country spillovers.

Finally, the litigation-risk updating explanation of country spillovers implies that a non-sued foreign firm’ price reactions to its country peers’ lawsuits are related to its future litigation risk, if investors’ litigation risk assessment process is efficient. We test this implication directly and find that the more negatively a non-sued firm’s stock price reacts to its country peers’ lawsuits in a year, the higher its chance to be sued subsequently. This finding not only directly supports the litigation-risk updating explanation of country spillovers, but also suggests that in general investors efficiently update litigation risks of non-sued foreign firms.

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3 It is not surprising to see pre-announcement price reactions to lawsuit filings, as potential lawsuits were typically publicly disclosed or even reported in the media when law firms gathered sufficient number of shareholder claims.

4 We observe negative price reactions even among non-sued foreign firms originated from a different country than the sued firms. It could be due to litigation information spillovers through other channels, for example, industry spillovers documented in Gande and Lewis (2009). Another possibility is the (downward) bias in our abnormal return measurement. As such, we rely on the difference in abnormal returns between non-sued country peers and other non-sued foreign firms to infer country spillovers.
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