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Earnings management, lawsuits, and stock-for-stock acquirers' market performance ☆

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ABSTRACT

There is a positive association between stock-for-stock acquirers' pre-merger abnormal accruals and post-merger announcement lawsuits. The market only partially anticipates the effects of post-merger announcement lawsuits at the merger announcement and the post-merger announcement long-term market underperformance is largely limited to litigated acquisitions. Overall, the evidence suggests that it is important that investors not only undo the direct stock price effects of earnings management but also factor the contingent legal costs associated with earnings management.

1. Introduction

Louis (2004a) suggests that the reversal of the effects of pre-merger abnormal accruals is a significant determinant of stock-for-stock acquirers' long-term underperformance. While Louis (2004a) partly attributes long-term underperformance after stock-for-stock mergers to the reversal effects of pre-merger earnings management, he does not consider the potential litigation costs associated with pre-merger earnings management. In this study, we analyze whether post-merger announcement lawsuits are associated with pre-merger abnormal accruals and the potential effects of lawsuits on acquirers' market performance.

We posit that, by subjecting stock-for-stock acquirers to lawsuits, pre-merger earnings management can have an indirect effect on acquirers' performance around and after the merger announcement, in addition to the direct effect associated with post-merger accrual reversals. Post-merger lawsuits are likely to be very costly for various reasons. First, plaintiffs generally receive large monetary settlements in acquisition-oriented class action suits (Thompson and Thomas, 2003). Second, lawsuits tend to distract management at the very moment when it should be concentrating on integrating the merging partners. For instance, the members of the Hewlett-Packard (HP) and Compaq integration team maintained

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that lawsuits severely hampered their integration plan and decision making (Swartz, 2002). Many analysts believe that the distraction and the ensuing loss in employee morale caused by these lawsuits seriously hurt HP to the benefit of its competitors (see, e.g., Sullivan, 2002). Some analysts then conclude that mergers are likely to destroy value, not necessarily because the acquisitions are bad, but because firms that are embroiled in merger battles fall behind their competitors (Etzel, 2002).

After analyzing the association between pre-merger announcement abnormal accruals and post-merger announcement lawsuits, we examine whether the market anticipates the potential lawsuits and their consequences at the merger announcement. It is well documented that the average stock-for-stock acquirer experiences significant market losses at the merger announcement. Louis (2004a) suggests that earnings management is a significant determinant of acquirers' losses in the days leading to stock-for-stock merger announcements. Other potential explanations for the losses include the hubris hypothesis (Roll, 1986), the signaling hypothesis (Leland and Pyle, 1977; Jensen and Ruback, 1983; DeAngelo et al., 1984; Travlos, 1987), and the winner's curse hypothesis (Varaiya and Ferris, 1987). However, no study has examined whether merger announcement losses reflect the increased probability that an acquirer will face a lawsuit.

In a fully efficient market, the probability of a lawsuit should be reflected in the market reaction to the merger announcement. However, extant studies suggest that the market does not efficiently process the valuation implications of stock-for-stock mergers. They find that acquirers underperform in the years after the merger announcement (Loughran and Vijh, 1997; Louis, 2004a; Moeller et al., 2005). As Jensen and Ruback (1983, p. 20) comment, the "post-outcome negative abnormal returns [after takeovers] are unsettling because they are inconsistent with market efficiency." Thus, a priori, it is not clear whether, and to what extent, the market reaction to the merger announcement impounds the probability of a lawsuit.

To examine the association between the merger announcement abnormal return and the probability of a lawsuit, we use an instrumental variable approach. In a first step, we estimate the probability that an acquirer would be sued, using ex-ante predictors of lawsuits. In a second step, we analyze the association between the merger announcement abnormal return and the probability of a lawsuit. We use the two-stage estimation process because of the potential endogeneity in the relation between lawsuits and performance.

A negative association between the probability of a post-merger announcement lawsuit and the market reaction to the merger announcement would be consistent with the notion that the merger announcement return impounds the probability of a lawsuit. However, it is plausible that the probability of a lawsuit is only partly impounded at the merger announcement. In this case, the post-merger stock performance will also be related to the probability of a post-merger announcement lawsuit. Thus, we also analyze the association between stock-for-stock acquirers' long-term abnormal returns and the ex-ante probability of a post-merger announcement lawsuit.

Consistent with our conjectures, we find that pre-merger abnormal accruals are a strong determinant of post-merger lawsuits. The effect of abnormal accruals is significant even after controlling for the post-merger abnormal return, which suggests that pre-merger earnings management has a first-order effect on the likelihood of a lawsuit. We also find evidence that the market anticipates the lawsuits at merger announcements. There is a significantly negative association between the market reaction to a merger announcement and the probability that a stock-for-stock acquirer is subsequently sued.

Further analyses suggest, however, that the market reaction to the merger announcement only partially reflects the probability of a lawsuit. First, we find that stock-for-stock acquirers' long-term market underperformance is largely limited to litigated acquisitions. The average stock-for-stock acquirer that does not face a merger-related lawsuit experiences a statistically insignificant abnormal return of approximately -11.4% relative to a match firm over the 4 years after the merger announcement. In contrast, the average acquirer in litigated mergers experiences an abnormal return of -77.7% over the same horizon. Second, and more importantly, we find a very strong negative association between the likelihood of a lawsuit and the long-term market performance over the 4 years after the merger announcement. Therefore, post-merger announcement long-term market performance can be predicted using lawsuit-related information that is available at the time of the merger announcement.

We do not claim that lawsuits are the only cause of the post-merger announcement long-term underperformance. The evidence only indicates that lawsuits are a contributing factor to the underperformance, which is a very important finding, given the puzzling nature of the post-merger underperformance and the heightened interest in explaining this phenomenon.

The remainder of the study is organized as follows. The next section discusses related studies. Section 3 describes the sample selection process. Section 4 presents univariate analyses. We conduct multivariate regression analyses in Section 5. The study concludes in Section 6.

2. Related studies and motivation

Prior studies suggest that managers have strong incentives to inflate earnings prior to stock-for-stock mergers and provide supporting evidence that, on average, acquiring firms report large income-increasing abnormal accruals prior to merger announcements (Erickson and Wang, 1999; Louis, 2004a). Jensen (2005) also contends that overvalued firms tend to inflate earnings and to undertake stock acquisitions to create the illusion of growth to satisfy market expectations. However, Ball and Shivakumar (2008) argue that, because large corporate events are "characterized by higher than usual litigation and regulatory risk from inflating earnings," managers should be dissuaded from manipulating their reported earnings around these events.