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Litigation exposure, capital structure and shareholder value: the case of Brooke Group

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Abstract

We examine value creation and destruction in the tobacco industry due to the radical litigation strategy of Brooke Group CEO Bennett LeBow. Brooke Group had tiny market share, low margins, high leverage and highly concentrated management ownership. Beginning in 1996, the firm reached settlements in lawsuits brought against all cigarette companies by class action plaintiffs and US state governments. Brooke Group's actions, which included promises to cooperate in litigation against its rivals, spurred other companies to reach settlements on less favorable terms. These events led to massive wealth destruction within the industry but impressive returns for shareholders of Brooke Group.

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1. Introduction

On March 13, 1996, Bennett LeBow, Chairman, CEO and controlling shareholder of Brooke Group, announced that his firm had agreed to settle *Castano vs. American Tobacco*, 84 F 3d 734 (1996), a class action lawsuit filed by cigarette smokers against the major US tobacco companies. Within 2 days, LeBow also reached settlements with five US states that

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had sued cigarette manufacturers to recover the cost of tobacco-related Medicaid and Medicare expenses. A more comprehensive settlement between LeBow's company and 22 plaintiff states followed in March 1997. By breaking ranks with industry counterparts who had steadfastly maintained no responsibility for health hazards of smoking, LeBow set the stage for the larger settlement that the industry reached with 46 state governments in November 1998.

Brooke Group (since renamed Vector Group) owned a controlling interest in Liggett, the fifth largest cigarette maker in the US. Liggett had a tiny market share, and Brooke Group's capital structure and ownership pattern differed significantly from those of other tobacco companies. Brooke Group's settlements of smoking lawsuits had a dramatic impact on share prices throughout the industry: over the 2 days following the initial March 1996 announcements, more than US$7 billion disappeared from the market capitalization of other tobacco companies, while Brooke Group's equity value rose by US$30 million, a net-of-market gain of nearly 20%. Similar patterns of returns occurred over the subsequent 3 years as the tobacco industry's litigation strategy evolved from defiance toward conciliation. Brooke Group shareholders earned returns that were modest in dollar value but enormous in percentage terms, as LeBow repeatedly obtained lenient settlements for his company while agreeing to assist plaintiffs and regulators in their efforts against his far larger rivals. In contrast, other tobacco investors lost billions as the legal environment's deterioration—abetted by LeBow's cooperation with outsiders—motivated companies to settle litigation on terms they had once viewed as inconceivable.

This paper follows LeBow's management of Liggett beginning in 1986, when he purchased its tobacco operations from Grand Metropolitan in a highly leveraged transaction. In many ways, Liggett and LeBow epitomized the move towards debt financing and concentrated ownership in corporate America during the 1980s. In a series of mostly unsuccessful investments, LeBow pursued a strategy of buying financially troubled companies with junk bond financing, raising their value through asset sales and operational improvements and recouping his investment by selling a minority stake in an initial public offering. This approach was designed to give LeBow handsome profits on his initial investment while allowing him to retain residual control of the firm. His performance as a creator of shareholder value was at best mixed. *Business Week*, in a 1996 profile, described LeBow as a ''minor-league bottom-fisher'' and ''third-tier wheeler-dealer'' (Lesly, 1996), and several of his investments led to bankruptcies and shareholder lawsuits. Table 1 gives a chronology of LeBow's major ventures apart from Liggett.

Stock return data indicate that LeBow's Brooke Group shareholders earned handsome returns while other tobacco company stocks performed poorly amid the turmoil LeBow helped create. Fig. 1 shows the value over time of a US$1.00 investment in the four public US tobacco stocks on August 1, 1995, the approximate beginning of LeBow's restructuring activities. The graph extends to September 30, 1999, soon after the announcement of the US federal government's lawsuit against the industry. For comparison purposes, the results of a US$1.00 investment in the S&P 500 Index are also shown. A US$1.00 investment in Brooke Group would have grown in value to US$4.35 during the time studied, compared to an outcome of US$2.28 from investing in the market index. All three