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, Bennet LeBow, Chairman, CEO and controlling shareholder of Brooke Group, announced that his firm had agreed to settle \textit{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...
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 out-
siders—motivated companies to settle litigation on terms they had once viewed as in-
conceivable.

This paper follows LeBow’s management of Liggett beginning in 1986, when he 
purchased its tobacco operations from Grand Metropolitan in a highly leveraged trans-
action. 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 restruct-
uring 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
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