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Does disclosure deter or trigger litigation?☆

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Abstract

Securities litigation poses large costs to firms. The risk of litigation is heightened when firms have unexpectedly large earnings disappointments. Previous literature presents mixed evidence on whether voluntary disclosure of the bad news prior to scheduled earnings announcements deters or triggers litigation. We show that the counterintuitive finding in prior literature that disclosure triggers litigation could be driven by the endogeneity between disclosure and litigation. Using a simultaneous equations methodology, we find no evidence that disclosure triggers litigation. In fact, consistent with economic arguments, our evidence suggests that disclosure potentially deters certain types of litigation.

JEL classification: M41; K22; G39; C30

Keywords: Stockholder litigation; Earnings disclosures; Endogeneity

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1. Introduction

Securities lawsuits are costly to firms. They divert management time away from more productive efforts, involve substantial attorney fees, and can damage the reputation of the firm and its managers. The risk of litigation is heightened when firms' earnings are substantially lower than investors expected. In these cases firms have strong incentives to employ mechanisms to lower their legal exposure. Lev (1992) and Skinner (1994) suggest that preemptive measures such as voluntarily issuing an earnings warning can potentially *decrease* the probability of a lawsuit, yet they do not provide direct evidence on the deterrence effect of voluntary disclosure. In fact, the only direct evidence regarding the effects of early disclosure on the likelihood of litigation comes from Francis et al. (1994). Interestingly, they find the opposite result, i.e., early disclosure *increases* the probability of a lawsuit.

Both the Skinner paper and the Francis et al. paper have been influential and widely cited in the literature. Given the opposite conclusions drawn in these papers, it is surprising that there has not been more research on whether disclosure deters or triggers litigation. In their review paper, Healy and Palepu (2001) highlight this relation between early disclosure and litigation and note that the empirical evidence is mixed. Similarly, Johnson et al. (2001) characterize this issue as a "controversy in prior literature." In this paper we try to reconcile the conflicting views in the literature by providing more direct evidence on the complex relation between early disclosure and litigation risk.

Several factors potentially cause earnings warnings to decrease the likelihood of being sued. First, Skinner (1994) argues that early disclosure weakens the claim that managers acted improperly by failing to disclose the information promptly, thus lowering the probability of a lawsuit. Second, voluntary disclosure might reduce the contingent loss in the case of a lawsuit. Skinner (1997) documents that more timely disclosure leads to a lower settlement amount even if a lawsuit cannot be avoided. By informing the market of bad news before the scheduled earnings announcement, the firm decreases the amount of time that the stock trades at misleading prices, thus decreasing recoverable damages. Third, with lower potential damages, plaintiffs' incentives to bring a lawsuit are reduced. Finally, a stylized fact is that class action lawsuits tend to be precipitated by large one-time stock price drops (e.g., Francis et al., 1994; Grundfest and Perino, 1997). Partially revealing the bad news through voluntary disclosure might reduce lawsuit probability by avoiding a single, large stock price drop upon the earnings announcement.

Of course, there are also costs to disclosure. Examples include the direct costs of preparing and disseminating information and also various indirect costs such as revealing proprietary information to competitors (e.g., Dye, 1986; Darrough and Stoughton, 1990; Graham et al., 2004). For firms with low litigation risk, the costs of disclosing may exceed the benefits, and consequently these firms will choose not to disclose bad news early. Kasznik and Lev (1995) and Shu (2003) find that about 50% of their sample firms that experienced earnings disappointments issued some form of earnings warnings, while the other 50% remained silent.