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The effect of securities litigation on external financing



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ABSTRACT

Using a comprehensive sample of securities litigation, we examine the effect of financial fraud on the subsequent use of external financing. We find that firms with a recent history of securities litigation, particularly more severe litigation, are less likely to seek external debt and equity financing. This negative relationship between prior litigation and external financing is stronger for firms with high information asymmetry. Furthermore, firms significantly reduce their investments in capital expenditures and research and development during the three years following a litigation filing. Thus, the reduction in the availability of external financing due to allegations of financial fraud can have a tangible impact upon the investment opportunities of the firm

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1. Introduction

Financial fraud remains on the rise and is becoming increasingly egregious despite multiple regulatory attempts and public demands for a more aggressive prosecution of white collar crime. In addition to its enormous cost to taxpayers, it is equally expensive for the firms' shareholders. Firms prosecuted for financial misconduct incur considerable procedural expenses and are subject to court-imposed penalties or settlement expenses. Moreover, these litigation costs are usually dwarfed by multiple indirect costs, which include a loss in market value (Gande and Lewis, 2009), reputational consequences (Alexander, 1999; Karpoff et al., 2008a; Karpoff and Lott, 1993), executive turnover (Karpoff et al., 2008b), potential changes in governance and corporate strategy (Farber, 2005; Marciukaityte et al., 2006), and greater valuation uncertainty (Murphy et al., 2009).

We study the consequences of financial fraud by investigating the effect of alleged financial misconduct, measured by securities litigation, on firms' access to external financing. Our empirical tests rely on a comprehensive sample of 11,354 securities lawsuits filed between 1987 and 2009. Lawsuits falling under the umbrella of securities litigation commonly include, but are not limited to, such offenses as financial misrepresentation or misreporting, the release of misleading forward-looking statements, stock price manipulation, insider trading, option backdating, and violations related to mergers and acquisitions or sales of securities. Whether the fraud is intended to benefit the firm's shareholders or its managers, it signals an agency problem and

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¹ In its recent report on financial crimes, the Federal Bureau of Investigation (FBI) identified corporate fraud as one of its highest priorities. In 2011, the FBI investigated 726 violations involving false accounting, fraudulently inflated assets, insider trading, and kickbacks. The number of cases increased by 10% from 2010. See http://www.fbi.gov/stats-services/publications/financial-crimes-report-2010-2011.

greater risk of transacting with well-informed opportunistic insiders. Therefore, securities litigation can negatively impact a firm's access to the capital markets by increasing its valuation uncertainty and thereby raising its cost of capital.²

We find that firms with a recent history of securities lawsuits reduce external financing. In particular, following the filing of securities litigation against them, firms are significantly less likely to raise external financing after controlling for stock returns, growth opportunities, and other cross-sectional factors affecting securities issuances. The negative relation between securities litigation and external financing is both statistically and economically significant. For example, during the three years after the filing of securities litigation (a period in which the typical lawsuit is in progress), the amount of net external financing as a percentage of total book assets is reduced by 5.6%, which is large in relation to the unconditional mean of 20%. Similarly, securities litigation decreases net equity issuance by 4.3% of book assets relative to the unconditional mean of 12.4%. Furthermore, securities litigation decreases net debt issuance by 1.4% relative to the unconditional mean of 7.5%. These findings are robust to the exclusion of small offerings. Our results are also robust to alternative measures of securities issuance and time lags between litigation and external financing, although debt financing is somewhat less sensitive to securities litigation.

We also report a negative relation between litigation severity and external financing when we measure severity by the number of securities lawsuits brought against a firm or focus on lawsuits that are subsequently lost or settled. This finding indicates that firms with more egregious offenses subsequently raise less external financing. While this finding is intuitive, it is surprising that our baseline results that use a firm-year litigation dummy variable yield such statistically and economically significant results, indicating that a mere filing of securities litigation represents a significant business disruption. One reason for this finding could be the heightened pleading standards established by the Private Securities Litigation Reform Act (PSLRA) of 1995 to discourage meritless class action litigation, which subsequently led to higher dismissal rates. Our results suggest that even though the lawsuit can be dismissed, capital market participants may still take the allegations into account when making financial decisions.

We also document cross-sectional differences in the effect of litigation on external financing. Since information asymmetry plays a critical role in security issuance, we examine whether litigation affects external financing differently for firms with high versus low pre-litigation information asymmetry. We use four proxies for information asymmetry based on firm financial characteristics, access to monitoring, and firm governance: firm size, volatility of stock returns, institutional ownership, and the proportion of independent directors on the board. The results provide some evidence that litigation has a stronger negative effect on external financing for firms with high information asymmetry.

Finally, we find that securities litigation coincides with a profound economic change in defendant firms' investing activities. We observe that firms with a recent history of securities litigation reduce their levels of investment in capital expenditures and research and development relative to a sample of matched firms without litigation. This result is consistent with a rise in the cost of capital and an associated decrease in the pool of profitable investment opportunities.

Overall, this study broadens our understanding of litigation costs associated with corporate misconduct by focusing on the consequences of securities litigation for firms seeking external financing. Studies of external financing after earnings restatements (Chen et al., 2013; Wang et al., 2013), a potential case of financial wrongdoing, provide the initial insight that financial fraud in general can adversely affect the terms of external financial contracting. We undertake a deeper investigation by relying on alleged financial misconduct that is distinct from accounting restatements and ranges from option backdating to violations related to mergers and acquisitions.³ Our results demonstrate that financial wrongdoing, whether it is intended to enrich existing shareholders or the firm's managers, indicates a severe agency problem and is costly to the firm in both the short- and long-term as investors take into account the greater risks of transacting with well-informed opportunistic insiders. A key insight from our analysis (made possible by our large sample) is that more severe financial misconduct has a more profound effect on subsequent external financing. Lastly, our research complements Murphy et al. (2009), who show that class action litigation is followed by increases in firm risk which should affect the firm's cost of capital, although they do not directly test this conjecture. Our results are consistent with a rise in the cost of capital.

The remainder of the paper is organized as follows. In Section 2, we review the extant literature, provide background information, and develop our hypotheses. Our sample construction is discussed in Section 3. The following section consists of our empirical analyses, including a discussion of the results. Finally, we summarize our findings and provide concluding remarks in Section 5.

2. Literature review

2.1. Corporate misconduct costs

An extensive stream of literature documents significant costs associated with corporate litigation. Several studies find a large market value loss induced by its revelation. Fich and Shivdasani (2007) report average cumulative abnormal returns of -16%

² An alternative channel through which litigation can negatively impact external financing is by adversely affecting the firm's reputation and its relationships with customers and suppliers, reducing its investment opportunities and, therefore, the need for financing. This effect could reasonably be connected with an increased cost of capital, therefore we focus on the cost of capital argument throughout the paper.

³ Recent reports on the composition of class action litigation by Cornerstone Research indicate that about forty percent of all filings were due to accounting problems and only about a third of those resulted in restatement. Thus, only about 13% of class action litigation filings are associated with restatements. The reports can be found at http://www.cornerstone.com/getattachment/68477e23-6aae-43b6-b632-6a9068ed8f0a/Accounting-Class-Action-Filings-and-Settlements-Re.aspx.

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