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Shareholder litigation and changes in disclosure behavior ☆

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ABSTRACT

We examine changes in the disclosure behavior of firms involved in 827 disclosure-related class-action securities litigation cases filed between 1996 and 2005. We find no evidence that the firms in our sample respond to the litigation event by increasing or improving their disclosures to investors. Rather, we find consistent evidence that firms reduce the level of information provided post-litigation. Our results suggest that the litigation process encourages firms to decrease the provision of disclosures for which they may later be held accountable, despite the increased protections afforded by the Private Securities Litigation Reform Act of 1995.

1. Introduction

Whether shareholder litigation is an effective governance mechanism has long been questioned. Some view the majority of securities lawsuits as frivolous suits resulting in outsized payouts to plaintiffs' attorneys and only minimal compensatory payments to shareholders.[2] Others claim that private litigation provides many important benefits including a deterrent effect, tempering managers' inclination to violate securities laws for personal enrichment.[3] While the deterrent

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[2] As Coffee (2006) notes, the Private Securities Litigation Reform Act of 1995 (PSLRA) was "clearly a product of this sense that securities class actions were disproportionately non-meritorious."

[3] An amicus brief filed by the Department of Justice and the Securities and Exchange Commission in Tellabs v. Makor Issues & Rights, Ltd. states that private actions "are an essential supplement to criminal prosecutions and civil enforcement actions brought, respectively, by DOJ and the SEC" (Cartwright et al., 2007).

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function of private litigation has been studied in some detail, we investigate the existence of another potential benefit of securities litigation: a change in the conduct of the firms involved in private litigation.

We study the disclosure behavior of firms involved in 827 disclosure-related shareholder lawsuits between 1996 and 2005. In the past, both academics and regulators have been concerned with how the threat of private securities litigation affects corporate disclosure behavior, but little is known about the behavioral changes of companies that are actually sued. By observing the disclosure changes of managers who have developed more precise beliefs about the relation between disclosure and litigation, we gain a better understanding of the direct effects of litigation on the targeted firms.

Using both direct and indirect measures of voluntary disclosure, we compare pre-litigation disclosure behavior to the firm's disclosure choices following litigation. After controlling for economic performance and other determinants of disclosure, we find consistent evidence that firms reduce the amount of information provided to investors after being subject to disclosure-related litigation. This reduction takes many forms: The probability of a firm hosting an earnings-related conference call[4] or issuing an earnings forecast is lower following litigation. When firms choose to issue earnings forecasts, those forecasts are issued for shorter horizons and are less likely to be quantitative. When quantitative forecasts *are* issued, those forecasts are less specific (i.e., wider range estimates). Similarly, we find evidence of reduced information flow using indirect measures of disclosure behavior. Specifically, we find an increase in the magnitude of future earnings surprises and an increase in the absolute value of earnings announcement excess returns. We find no evidence that this reduction in disclosure is driven by a decrease in the firm's forecasting ability; management forecast accuracy is indistinguishable post-litigation compared with a 12-month window prior to the damage period. Our results hold after controlling for other potential determinants of disclosure choices such as CEO turnover, demand for disclosure, and economy-wide trends in disclosure.

While we do not directly test causality, our evidence suggests that managers emerge from the litigation process with a belief that a higher level of voluntary disclosure does *not* reduce the expected cost of litigation. Rather, our findings are consistent with managers adopting the belief that plaintiff attorneys will use voluntary disclosures to accuse managers of misconduct, even when the disclosures were made in good faith. Additionally, to the extent that managers emerge from the litigation process with a perception of greater litigation risk going forward, our results are in accord with prior research claiming a negative relation between litigation risk and voluntary disclosure (e.g., Frost and Pownall, 1994; Johnson et al., 2001; Baginski et al., 2002).

Two recent developments emphasize the importance of our research question. First, several European countries are debating whether to adopt class action statutes or how to improve their existing class action statutes (The Economist, 2007). Often, these debates focus on whether these governments should adopt aspects of a US style litigation environment. Knowledge of how sued firms change their disclosure behavior in response to litigation allows for a more informed debate about the costs and benefits of class action statutes.

Second, there is growing evidence that litigants are not solely interested in cash recoveries, but are also concerned with ensuring that the targeted companies make real changes. These changes include corporate governance reform and commitments to increased disclosure (Plitch, 2005). For instance, Bristol-Myers Squibb Company (BMS) recently agreed to settle a case in which investors alleged that the company knew but failed to disclose several adverse outcomes in the drug trials of Vanlev. BMS agreed to settle the claims for $185 million and further agreed to "publicly disclose the clinical study design and the results of clinical trials, including the reporting of adverse events, for each and every drug that is marketed in the United States or any other country" (Baretz, 2006).[5]

Overall, our findings raise the question of whether the post-suit behavior displayed by firms involved in litigation is consistent with the goals of regulators or private litigants. Specifically, if regulators are interested in timely and informative disclosures, they may be troubled that the current environment results in exactly the opposite for firms involved in litigation. In addition, if litigants desire improved disclosure going forward, they may need to explicitly include such changes in settlement agreements, rather than hope the target firms improve their disclosure voluntarily.

The remainder of the paper is organized as follows: Section 2 discusses the prior research and develops our hypotheses. Our empirical design is described in Section 3. Section 4 discusses our sample selection and the characteristics of the firms in our sample. The results of our empirical tests are described in Sections 5 and 6. Section 7 concludes.

2. Prior research and hypothesis development

The basic premise of our paper is that lawsuits cause managers to revise their beliefs about the costs and benefits of their current disclosure strategy, resulting in post-lawsuit disclosure changes. After being presented with specific allegations of improper disclosures, managers are likely to gain a more precise understanding of the relation between disclosure and litigation. In addition, prior research suggests that, *ceteris paribus*, managers' expectations of future litigation

[4] Throughout the paper, we use the terms "earnings-related conference call" and "conference call" interchangeably. We use both of these terms to refer to conference calls that were held within three calendar days of the firm's earnings announcement date.

[5] The inclusion of governance and disclosure reforms in class actions settlements is a controversial phenomenon. Critics of these "governance at gunpoint" agreements question whether lead plaintiffs accept lower cash settlements in exchange for reforms. Since the class typically includes both past and current shareholders, these critics argue that past shareholders do not benefit from the reform but incur some of the costs through lower cash settlements (Plitch, 2005).