THE UNINTENDED CONSEQUENCES OF SECURITIES LITIGATION

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ABSTRACT

This paper reviews the economics and finance literature to infer the economic consequences of securities litigation. The focus is on the measurable economic consequences, rather than the unquantifiable adverse or beneficial effects of litigation on companies. The main findings are that:

- At a minimum, information-disclosure-related litigation destroys on average approximately 3.5 percent of the equity value of a company (Thakor, Nielsen and Gulley (2005)). This implies that at least $24.7 billion in shareholder wealth was wiped out just due to litigation.

- The wealth destruction in litigation is not a zero-sum game of transfer payments from defendants to plaintiffs. The wealth destroyed for defendants far exceeds the wealth gained by plaintiffs. Thus, litigation seems to create deadweight losses.

- Smaller defendant firms seem to suffer greater percentage wealth losses in litigation.

- Information-disclosure-related litigation appears to create incentives for investors to sue “excessively” due to the possibility of predictably profitable trading strategies in “litigation-prone” securities.

- Firms invest more capital when stock prices are high and substitute capital investment with cost-cutting measures when stock prices are low. Hence, the lowering of a firm’s stock price due to litigation could result in lower capital investments by firms, which has obvious implications for job creation and economic growth.
I. INTRODUCTION

Economists and legal scholars have long wondered about the economic consequences of securities litigation specifically and also litigation in general (see, for example, Bizjak and Coles (1995), Johnson, Nelson and Pritchard (1999), and Johnson, Kasznik and Nelson (2001)). Olsen (1991) has stated that corporate litigation is so pervasive and pernicious that it “… clogs and jams the gears of commerce.” While this statement is clearly too strong in that it focuses on an \textit{ex post} (\textit{i.e.} after the fact) consequence of litigation rather than its \textit{ex ante} (\textit{i.e.} prior to the information disclosure) beneficial incentive effects in altering the behavior of those who would flout the law in the absence of litigation, it nonetheless highlights what many believe are some of the undesirable aspects of litigation. The undesirable aspects arise because often the actual effects of litigation are not the effects intended by the law that created the legal basis for the litigation in the first place.

This “principle of unintended consequences” is illustrated in an interesting way by the antitrust enforcement actions against Microsoft. The intended consequence of these actions was ostensibly to curb Microsoft’s “monopoly power” in the computer industry and create a more level playing field for its competitors, thereby improving the outlook for these competitors and the industry as a whole. The actual outcome, as judged by the stock market, was the opposite. Between 1991 and 1997, 29 reports of federal antitrust enforcement actions against Microsoft were accompanied by significant declines in the value of an index of 159 computer industry firms (\textit{excluding} Microsoft). The average loss to these firms exceeded $1 billion per event. Moreover, eight setbacks in enforcement - when the federal government was unable to proceed with its originally-planned enforcement action - were associated with increased computer sector value (\textit{see} Bittlingmayer and Hazlett (2000)).

In this article, my focus is on securities litigation. In particular, I am interested in addressing the economic consequences of securities litigation against firms pertaining to alleged misrepresentation of information provided to investors; such litigation is associated with the Securities Act of 1933, the Securities Exchange Act of 1934 and the Private Securities Litigation Reform Act of 1995. In doing this, we review the existing research on this topic, which is quite extensive and leads to noteworthy conclusions.
A summary of the main findings revealed by this literature review are given below:

- The market values of firms decline due to securities litigation itself, and this is distinct from the joint effect of the litigation and the revision in firm value due to the disclosure of bad news.
- Litigation does not appear to be a zero-sum game, in that the wealth destruction experienced by defendants significantly exceeds the wealth gain experienced by plaintiffs.
- The wealth destruction due to litigation that is experienced by defendants, as a percentage of their equity market value, seems to be larger for smaller firms.
- Securities litigation creates “options” for plaintiffs, thereby generating a propensity for excessive litigation. In particular, there may exist trading strategies for diversified investors that permit them to selectively sell some securities and hold on to others until after the class period (thereby sharing in the settlement amount) in order to generate portfolio profits.
- The stock price decline due to securities litigation may cause a decline in corporate investment.

My conclusion is that securities litigation has the potential to generate a wide range of unintended economic consequences. I discuss these issues in Section II. Of course, this is not intended to suggest that either the litigation that follows suspected violations of securities laws or the securities laws themselves have no economic benefits. Litigation may have unquantifiable costs and benefits that are not captured by the analysis in the research reviewed here. I discuss this issue in Section III, which is the concluding section. The purpose of this article is not to offer a comprehensive analysis of the costs and benefits of securities regulation or the associated litigation, but rather to discuss the economic implications of securities litigation that were unlikely to have been anticipated when securities laws were framed.

II. ECONOMIC CONSEQUENCES OF SECURITIES LITIGATION

An important issue is to assess the economic consequences of securities litigation through its impact on stock prices and the investment decisions of firms. There are at least five aspects to this assessment. First, what is the impact of the litigation itself on the stock price of the defendant and how much wealth does it destroy? Second, how can we measure this wealth effect separately from the negative impact of the adverse information disclosure on the firm’s stock
price? Third, is litigation merely a zero-sum game in the sense that the decline in the value of the defendant is equal to the increase in the value of the plaintiff? Fourth, does the present system create economic incentives for investors to “over-litigate?” And finally, how does the impact of litigation on the defendant’s stock price affect its investment decisions? The last question has potential implications for capital formation and economic growth.

A. Wealth Destroyed by Litigation

The first two of these questions are addressed by Ferris and Pritchard (2001) in an empirical study of the stock market’s reaction. The study uses a sample of defendant firms and conducts an event study at three separate points in time in the litigation process: (1) the revelation date of the potential misrepresentation/fraud giving rise to the lawsuit; (2) the notice date for the filing of the first complaint; and (3) the decision date of the district court for the initial motion to dismiss brought by the issuer/defendant. Of interest to us are points in time (1) and (2).

The paper presents striking evidence. The analysis reveals a strong negative price reaction of approximately 25 percent on average around the revelation date of the bad news, adjusting for movements in the stock price that could be expected on the basis of contemporaneous movements in the overall stock market. That is, the 25 percent is a cumulative abnormal return, which can be economically interpreted as the drop in the stock price primarily associated with the disclosure of bad news, rather than any other contemporaneous confounding events. This is not only statistically significant but is also a large economic magnitude. For example, for a company with a pre-disclosure equity market value of $1 billion, this would represent an almost instantaneous evaporation of $250 million in shareholder wealth.

One has to be careful in interpreting what this 25 percent drop means, because the decline represents a commingling of two forces that are simultaneously at work when the bad news is disclosed. One is the direct effect of the disclosure itself. This direct effect is manifested in a lowering of investors’ estimate of the firm’s future expected cash flows and/or a perception of higher future risk in cash flows, and it leads to a lowering of the firm’s stock price. In addition, there is also an indirect effect. When the bad news is disclosed, investors revise upward their assessment of the probability that the firm will be sued, and thus some portion of the 25 percent drop reflects investors’ assessment of how
much the value of the firm is expected to decline due to litigation. This decline in value due to litigation can potentially come from a variety of sources. The empirical evidence provided by other researchers suggests that some of these factors may be the costs of increased financial distress due to the litigation (see Bhagat, Brickley and Coles (1994) and Bizjak and Coles (1995)). Ferris and Pritchard’s (2001) analysis does not permit us to decompose this 25 percent value loss into the components attributable separately to the direct and indirect effects, so it is difficult to ascertain how much of the value loss comes from each effect. However, the existing body of research strongly suggests that some portion of the loss in value must come from the indirect effect of litigation.

Interestingly, Ferris and Prichard (2001) find that the subsequent event, namely the filing of the lawsuit, elicits an additional significant drop in the firm’s stock price. On average this drop is approximately 3.5 percent, after adjusting for expected movements in the stock price due to contemporaneous market movements. This decline in value cannot be attributed to anything but the effect of the litigation itself. Thus, we can say that a lower bound estimate of the reduction in firm value solely due to the litigation, as distinct from the effect of the disclosure of bad news, is about 3.5 percent. Given below are the actual results from Ferris and Pritchard (2001).

Table 1: Event Study Results Around the Revelation and Filing Dates
(taken from Ferris and Pritchard (2001))

<table>
<thead>
<tr>
<th>Event</th>
<th>Cumulative Abnormal Return (CAR)</th>
<th>Z Statistic</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bad News Revelation Date [-1, +1]</td>
<td>-0.2499 (or 24.99%)</td>
<td>-46.8168 (statistical significance at 1% level)</td>
</tr>
<tr>
<td>Notice of Complaint Filing Date [-1, +1]</td>
<td>-0.0347 (or 3.47%)</td>
<td>-5.55213 (statistical significance at 1% level)</td>
</tr>
</tbody>
</table>

Note: CARs are calculated using market model parameters estimated over the period prior to the information disclosure, Day -260 through Day -11.

What is the economic significance of these findings? To put this in perspective, note that the aggregate pre-disclosure market value of the 482 firms in the sample of firms analyzed in the companion research paper (Thakor, Nielsen and Gulley (2005)) was about $880 billion. The average decline in market capitalization for these firms at the
time of the disclosure of bad news was about 20 percent or over $175 billion, so that the aggregate post-disclosure market value was about $705 billion.\(^1\) A further 3.5 percent decline in value solely due to the effect of litigation means that a lower bound estimate is that approximately $24.7 billion in shareholder wealth was wiped out due to litigation.

We can juxtapose the 3.5 percent with the lawyers’ fees estimated in Thakor, Nielsen and Gulley (2005). There we find that these fees are about $3.1 billion, or over 0.5 percent of the total post-disclosure market values of the defendants.\(^2\) Of course, some of this $3.1 billion loss in market value may have been impounded in the $175 billion drop in market value at the time of disclosure because of anticipation by the market of future litigation costs. Thus, the portion of the 3.5 percent drop that is accounted for by lawyers’ fees is likely to be less than 0.5 percent of the post-disclosure market value. We can conclude that at least 3.0 percent (3.5 percent minus 0.5 percent) of the drop in the post-disclosure value loss arises from other types of transaction costs as well as other causes.

**B. Is Litigation a Zero-Sum Game of Simple Transfer Payments?**

One might be tempted to argue that even though the values of defendant firms decline, the overall economy may not be affected by litigation. This would be true, for instance, if litigation were a zero-sum game of simple transfers of wealth from defendants to plaintiffs.

At a theoretical level, there is reason to suspect that litigation in general is not a zero-sum game and that it generates deadweight costs. One way litigation can do this is by placing a firm in financial distress. Such financial distress can stem from lower sales or higher factor input costs because of a diminished ability to conduct business with customers and suppliers on favorable terms, greater cost and/or reduced access to credit, the distraction of management, and potential distortions in investment policy. The evidence provided by Altman (1984) and Hoshi, Kashyap and Stein (1990) indicates that these costs can be quite substantial.

Direct evidence that lawsuits destroy wealth was provided by Cutler and Summers (1988) who examined capital-market reactions to the various events in *Pennzoil vs.*

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\(^1\) This 20 percent probably understates the total erosion in market value due to the disclosure to the extent that there were partial disclosures or information leakages through time prior to the date of disclosure we consider.

\(^2\) As per Securities Class Action Services (SCAS), I have taken their data at face value.
Texaco, admittedly an unusual case.\textsuperscript{3} Cutler and Summers (1988) estimated that for each dollar Texaco lost, Pennzoil gained only 17 cents. This means that 83 percent of the wealth lost by Texaco was a \textit{deadweight loss} or a destruction of wealth that was not a benefit to Pennzoil. Cutler and Summers (1988) explain that the main reason for this wealth destruction is that the litigation imposed financial distress costs on Texaco. The executives at Texaco buttressed this explanation by stating that the lawsuit made it more difficult to finance and operate the business, whereas stock market analysts voiced concerns about Texaco’s inability to refinance debt, lost business opportunities, and losses due to management attention being diverted by the lawsuit.

One limitation of the Cutler and Summers (1998) study is that it examines only one firm. A large sample empirical study by Bhagat, Brickley and Coles (1994) suggests that the earlier Cutler and Summers (1988) finding extends more generally. This study involved 355 announcements of lawsuit filings and settlements between 1981 and 1983 that were reported in \textit{The Wall Street Journal}. The events in these announcements involved a wide range of issues: corporate control; breach of contract; patent infringement; antitrust; product defect/liability; securities/disclosure violations; bankruptcy issues; and slander.

The study found that for the average pair of opponent firms in the sample, the announcement of the filing resulted in a decline in the \textit{combined} equity value of about 1 percent, or approximately $21 million per firm. The authors conclude that the major

\textsuperscript{3} In early 1984, Pennzoil and Getty Oil agreed to the terms of a merger. But before any formal documents could be signed, Texaco offered Getty Oil a substantially better price, and Gordon Getty, who controlled most of the Getty shares, reneged on the Pennzoil deal and sold to Texaco. Pennzoil felt as if it had been dealt with unfairly and immediately filed a lawsuit against Texaco alleging that Texaco had interfered illegally in the Pennzoil-Getty negotiations. Pennzoil won the case; in late 1985 it was awarded $11.1 billion, the largest judgment ever in the U.S. An appeals court reduced the judgment by $2 billion, but interest and penalties drove the total back up to $10.3 billion. James Kinnear, Texaco’s CEO, had said that Texaco would file for bankruptcy if Pennzoil obtained court permission to secure the judgment by filing liens against Texaco’s assets. Furthermore, Kinnear had promised to fight the case all the way to the Supreme Court if necessary, arguing in part that Pennzoil had not followed S.E.C. regulations in its negotiations with Getty. In April 1987, just before Pennzoil began to file the liens, Texaco offered to pay Pennzoil $2 billion to settle the entire case. Hugh Liedtke, chairman of Pennzoil, indicated that his advisors were telling him that a settlement between $3 billion and $5 billion would be fair. Liedtke turned down Texaco’s offer of $2 billion, and within days – and only one day before Pennzoil began to file liens on Texaco’s assets – Texaco filed for protection from creditors under Chapter 11 of the U.S. bankruptcy code, as it had promised to do. Later in 1987, Pennzoil submitted a financial reorganization plan on Texaco’s behalf, under which Pennzoil would have received approximately $4.1 billion. Finally, just before Christmas, 1987, the two companies agreed on a $3 billion settlement as part of Texaco’s financial reorganization.
source of this wealth leakage appears to be the defendant’s financial distress due to the lawsuit.

In a related study, Bizjak and Coles (1995) examine the shareholder wealth implications of interfirm antitrust litigation and how the implied costs of the dispute influence the propensity to settle. They uncover numerous interesting results, the most striking of which is that the average decline in the joint market value of opposing plaintiff and defendant is $10.2 million, which means that upon the filing of a lawsuit, the defendant experiences a wealth loss that is on average $10.2 million larger than the wealth gains of the plaintiff. This is consistent with significant wealth destruction due to litigation, which probably captures not only the direct costs of litigation but also the impact of litigation on the firm’s business opportunities and on the decision making of a distracted or constrained management team.

None of these studies focused exclusively on information-disclosure-related securities litigation, although such lawsuits were a part of the set of lawsuits in the Bhagat, Brickley and Coles (1995) sample. However, this does not affect the inference that can be drawn from these studies for the potential wealth effects of information-disclosure-related securities litigation. The studies cited above document wealth destruction that they attribute largely to financial distress costs and a diminished ability to conduct business. This is true for any kind of litigation that imposes a significant financial cost on the defendant, hampers its ability to conduct business as usual and distracts management from its normal duties. Thus, while the magnitude of the average wealth destruction in information-disclosure-related litigation may not be exactly the same as the wealth destruction numbers cited here, one can nonetheless conclude that it is likely that such litigation is not a zero-sum game of simple transfer payments from defendants to litigants.

A noteworthy aspect of the damage suffered by defendants in securities litigation insofar as the transfer payment argument is concerned is that such litigation is fundamentally different from other types of litigation. In conventional cases of fraud, the wrongful gain received by one party is the loss suffered by the other, so that redressing the initially wrongful wealth transfer through litigation is an exercise in essentially reversing what should not have occurred in the first place. By contrast, in securities
litigation, the compensatory payments represent a transfer payment from previously “undamaged” shareholders—those who held on to their securities through the alleged fraud period—to “damaged” shareholders who acquired securities during the alleged fraud period. Given that the “undamaged” shareholders had nothing to do with perpetrating the alleged fraud, they are the unintended compensating party. Moreover, investors who profit from having sold at inflated prices are not required to disgorge their profits. The empirical estimates provided here do not account for the possible costs arising from such transfer payments and the associated effects on the behavior of investors and managers that may not be captured by stock price movements.

C. Does Firm Size Matter When it Comes to the Wealth Losses Suffered by Defendants?

An interesting question is whether the wealth losses suffered by defendants depend on the size of the defendant. Theoretically, there is reason to suspect that smaller firms are disadvantaged more since there may be economies of scale in dealing with lawsuits and larger firms may also be better able to absorb the financial distress costs associated with litigation.

A study by Bhagat, Bizjak and Coles (1998) provides an empirical answer to this question. On the issue of scale economies, the authors note that legal fees are quite substantial, suggesting that smaller firms may have greater difficulty in absorbing such costs with high fixed-cost elements. They note that salaries to in-house lawyers and fees to outside counsel for the 1,000 largest public companies reached $20 billion in 1991. Their analysis, which is based on a larger sample of firms than the one in their earlier paper (Bhagat, Bizjak and Coles (1994)), reveals that defendants experience statistically significant wealth losses upon the filing of a lawsuit. The average wealth loss for a defendant corporation is 0.97 percent of the market value of equity, or $15.96 million. Moreover, lawsuits involving violations of securities laws involve an average wealth loss of 2.71 percent of the market value of equity, which is larger than the average wealth loss in other types of lawsuits, such as antitrust and breach of contract. Most interestingly, the percentage decline in shareholder wealth associated with the actual or potential lawsuit is greater when the firm is smaller. This validates the theoretical conjecture made earlier.
The empirical finding that smaller firms are disadvantaged more in litigation means that the playing field is not level. Smaller firms are often viewed as the economy’s engine for innovation and growth. It is noteworthy that the economic losses suffered by these firms are greater.

D. Litigation Options and the Propensity to Sue

In an interesting paper, Cornell (1990) observed that litigation involves sequential decision making and hence is similar to financial options. The idea is that filing a lawsuit gives the plaintiff the right to proceed toward trial without having the obligation to try the case. Once the suit has been filed, the plaintiff has a variety of options. For example, he can choose to proceed quickly, whether to devote extensive resources to discovery, whether to make motions such as asking for a change of venue, and whether to make a settlement offer. These options make a lawsuit a more valuable investment that it would be if the plaintiff had to choose initially between trying the case and not filing a suit.

The empirical analysis in Thakor, Nielsen and Gulley (2005) suggests that a different kind of option may exist in the context of information-disclosure-related litigation. The analysis in that paper shows that litigation related to information disclosure involves investors making net profits after settlement in cases in which the firm did not significantly increase its outstanding equity during the class period. To the extent that this is a “trading strategy” with predictable gains, investors can profit by investing in a diversified portfolio of companies that they suspect are likely to be the subject of securities fraud litigation and then selling off their stakes in the subset of these companies that are observed to increase their equity outstanding during any time period. This will mean that these investors will profit from selling at inflated prices during the class periods for these securities, and will profit from the settlement amounts on the securities that they held on to that did not involve material increases in the shares outstanding.

This trading strategy has the potential to generate profits because it has the characteristics of a financial option. Securities on which the investor has a high probability of losing money by holding on to them beyond the class period—those involving increases in the outstanding equity—can be sold off as soon as an increase in equity is detected, thereby preventing losses. This is analogous to exercising a put option
when the stock price is below the strike price. On others, one waits for the litigation game to be played out.

Since it may be difficult to predict precisely which securities an investor should sell and which he should hold on to, such a trading strategy is most likely to succeed if one holds a diversified portfolio of “litigation-prone” securities. That is, large institutional investors, who tend to be diversified, are the ones most likely to succeed from such a trading strategy.

This is another example of the principle of unintended consequences. Since the empirical analysis in Thakor, Nielsen and Gulley (2005) shows that a key determinant of whether an investor profits or loses after settlement involving a litigated security is whether or not the outstanding equity increased materially, information-disclosure-related litigation appears to generate an observable event as a variable on which to condition a profitable trading strategy for investors. And this unintended consequence arises from the structure of the securities laws that govern such litigation, namely that investors are compensated for trading losses but are not asked to disgorge trading profits, and from the fact that many of the institutional investors are “repeat players” in the game in the sense that they take positions in a large number of litigated securities.

E. Litigation, Stock Prices and Corporate Investment

A somewhat controversial but important issue in economics and finance is the relationship between the stock market and corporate investment. Is the stock market merely a “side show,” reflecting changes in the underlying fundamentals of the economy and in corporate capital investments, without influencing any of these variables in the “real sector,” or is the real sector of the economy actually affected by the stock market? This question is important for us because the evidence shows that securities litigation generates deadweight losses and stock price declines, even apart from the price adjustments that accompany the disclosure of bad news. If stock prices affect corporate investments, then litigation, in and of itself, can have a deleterious ex post impact on corporate investment. Of course, this does not account for possible indirect incentive effects that may be positive from an ex ante perspective. For instance, the threat of litigation may induce managers to disclose more fully and accurately, thereby leading to more efficient pricing of securities.
One of the earliest theoretical arguments that rational managers should condition their investment decisions on stock prices was provided by Fischer and Merton (1984). In fact, Fischer and Merton argued that stock price levels represent an even more important factor in corporate investment than managerial assessments of fundamentals. Their argument is as follows. Whether a firm should invest in a given project depends on whether the expected return from that investment exceeds the expected return that the firm’s shareholders are currently demanding. What expected return shareholders are demanding can be gauged from the current stock price. A low stock price connotes a high expected return being demanded by investors and a high stock price connotes a low expected return. A lower expected return means a lower threshold expected return hurdle for the projects in which the firm wishes to invest. Since the numbers of projects with expected returns exceeding a lower threshold will be larger than the number of projects with expected returns exceeding a higher threshold, it follows that firms will invest more when their stock prices are higher.

The early empirical work in testing this hypothesis appeared to refute the hypothesis. Post-war annual aggregate U.S. data on stock returns and non-residential investment growth suggest that corporate investment and stock returns have a significant negative contemporaneous covariation, and investment and future stock returns have a covariation that is not statistically different from zero. The significant negative contemporaneous correlation represents a conundrum since it implies that firms perversely cut investment when stock prices go up (see Barro (1990), Chen (1991), Lamont (2000), and Poterba (1990), for example).

In an interesting study, Lamont (2000) provides further empirical insight. He argues that the perverse results cited above are probably due to investment lags, i.e., lags between investment plans and expenditures. Lags would prevent firms from immediately adjusting investment when the discount rate (or expected return on equity) changes, and can temporally shift the relationship between investment and stock returns. To account for this, Lamont conducts his tests using investment plans rather than actual corporate investments. His motivation is captured succinctly in a quote by Cochrane (1991): “If there are lags in the investment process, their investment will not rise for a few periods, but orders or investment plans rise immediately” (p. 213). The use of investment plans is
justified by the fact that they explain more than 75 percent of the variation in real annual aggregate investment growth.

Lamont’s (2000) empirical results strongly support the Fischer and Merton (1984) hypothesis. Planned future investment and future stock returns covary negatively over time in a statistically significant way, implying that high planned investment occurs when managers are forecasting low stock returns. This means firms formulate plans to invest more when stock prices are high.

The observation that firms invest more when their stock prices are high is not necessarily explained solely on the basis of the Fischer and Merton (1984) argument. For example, Dittmar and Thakor (2005) find that firms tend to invest more when they perceive greater investor agreement with their investment decisions, and periods of greater investor agreement tend to coincide with periods of high stock prices.

Another interesting empirical look at the problem is provided by Baker, Stein and Wurgler (2003). They ask: what are the conditions under which corporate investment is sensitive to nonfundamental movements in stock prices? Their key finding is that stock prices have a stronger impact on the investment of “equity-dependent” firms, which are the firms that need external equity to finance marginal investments. Firms that rank in the top 20 percent of equity dependence have investment that is almost three times as sensitive to stock prices as firms in the bottom 20 percent.

Finally, a recent working paper by Smith (2005) provides fresh new insights into how firms change behavior depending on their stock prices. Smith shows that high stock prices precede higher investments and low stock prices precede lower costs. That is, when a firm’s stock price is high, it attempts to increase future cash flow by investing more capital in projects. And when a firm’s stock price is low, it shifts its focus from investing capital in projects to cutting costs in its operations as a means to improve future cash flows.

Smith’s (2005) theory and empirical results provide rigorous research support for the anecdotal observation that many U.S. firms have been increasing their profits not by investing more, but by squeezing more and more from their cost structures and improving cost productivity. A legitimate question is how long companies can improve cost productivity to improve cash flows before capital investments are needed to drive further
growth. What Smith’s research indicates is that new investment is unlikely to occur until stock price levels increase.

Given that securities litigation lowers stock prices in and of itself, and lower stock prices induce firms to plan for lower capital investments, one can conclude that a potentially pernicious effect of such litigation is to cause a decline in corporate capital investment and growth, although the precise magnitude of this is difficult to assess.

III. CONCLUSION

This study has focused on the economic consequences of securities litigation related to alleged misrepresentation of information by firms. My analysis is based on an extensive review of the existing literature on the subject. My main conclusions are summarized below:

- At a minimum, information-disclosure-related litigation destroys on average approximately 3.5 percent of the equity value of a company (Thakor, Nielsen and Gulley (2005)) , this implies that at least $24.7 billion in shareholder wealth was wiped out just due to litigation.
- The wealth destruction in litigation is not a zero-sum game of transfer payments from defendants to plaintiffs. The wealth destroyed for defendants far exceeds the wealth gained by plaintiffs. Thus, litigation seems to create deadweight losses.
- Smaller defendant firms seem to suffer greater percentage wealth losses in litigation.
- Information-disclosure-related litigation appears to create incentives for investors to sue “excessively” due to the possibility of predictably profitable trading strategies in “litigation-prone” securities.
- Firms invest more capital when stock prices are high and substitute capital investment with cost-cutting measures when stock prices are low. Hence, the lowering of a firm’s stock price due to litigation could result in lower capital investments by firms, which has obvious implications for job creation and economic growth.

My focus has been primarily on the unintended adverse consequences of such litigation. I have investigated neither the root causes of such litigation in a broad economic sense, nor have I explored its potential ex ante benefits. In particular, I have not attempted any quantification of what may be the main, possibly unquantifiable potential benefit of Rule 10b-5 securities
litigation, namely that the threat of it may induce better disclosure incentives on the part of firms, leading to more efficient securities pricing (See Dutta and Nelson (1997)). I have also not addressed the unquantifiable costs that may be associated with Rule 10b-5 securities litigation. What I have shown is that the empirical evidence indicates that the effects of securities litigation that can be reliably measured show up as a deadweight loss.
REFERENCES


